No. 87-1160-ASX
Status: GRANTED

Title: Duquesne Light Company and Pennsylvania Power Company, Appellants
v.
David M. Barasch, etc., et al.

Docketed:
January 12, 1988

Court: Supreme Court of Pennsylvania, Western District

Counsel for appellant: Zeiter,William E.

Counsel for appellee: Pankiw,Bohdan R., Messer,Howard F., Popowsky,Irwin A.

NOTE: Notice of Appeal filed 1/7/88 cited

Entry	Date	Note	Proceedings and Orders
1	Jan 12 1988	G	Statement as to jurisdiction filed.
2	Jan 12 1988		Appendix of appellant Duquesne Light Co., et al. filed.
3	Feb 11 1988		Motion of appellee David M. Barasch, Consumer Advocate to dismiss or affirm filed.
4	Feb 17 1988		Reply brief of appellants Duquesne Light Co., et al. filed.
5	Feb 17 1988		DISTRIBUTED. March 4, 1988
6	Mar 7 1988		PROBABLE JURISDICTION NOTED.
			**********
8	Mar 29 1988		Order extending time to file brief of appellant on the merits until May 5, 1988.
9	Mar 30 1988	G	Motion of appellants to dispense with printing the joint appendix filed.
10	Apr 18 1988		Motion of appellants to dispense with printing the joint appendix GRANTED.
11	May 5 1988		Brief amicus curiae of Edison Electric Institute filed.
12	May 5 1988		Brief of appellants Duquesne Light Co., et al. filed.
13	May 5 1988		Brief amicus curiae of Pennsylvania Electric Assn. filed.
15	May 11 1988		Order extending time to file brief of appellee on the merits until June 20, 1988.
17	Jun 6 1988		Record filed.
		*	Certified copy of original record received.
16	Jun 10 1988		Order further extending time to file brief of appellee on the merits until June 30, 1988.
18	Jun 30 1988		Brief amici curiae of Energy Consumers of Pennsylvania, et al. filed.
19	Jun 30 1988		Brief amicus curiae of Natl. Assn. of State Utility Consumer Advocates filed.
20	Jun 30 1988		Brief amici curiae of Consumer Federation of America, et al. filed.
21	Jun 30 1988		Brief amicus curiae of Natl. Assn. of Regulatory Utility Commissioners filed.
22	Jun 30 1988		Brief of appellee David M. Barasch, Consumer Advocate filed.
23	Jun 30 1988		Brief amici curiae of National Governors' Association, et al. filed.
24	Jun 30 1988		Brief of appellee PA Public Utility Commn. filed.
25	Jul 20 1988		CIRCULATED.
26	Jul 29 1988	G	Application (A88-89) an extension of time within which to file a reply brief, submitted to Justice Blackmun.

No. 87-1160-ASX

Entry	Date	Note	Proceedings and Orders
28	Jul 30 1988		Application (A88-89) granted by Justice Blackmun extending the time to file until August 15, 1988.
29	Aug 12 1988	X	Reply brief of appellants Duquesne Light Co., et al. filed.
30	Aug 29 1988		Set for argument. Monday, November 7, 1988. (2nd case) (1 hr).
31	Nov 7 1988		ARGUED.

87-1160

No.

Supreme Court, U.S.
FILED
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CLERK

In The Supreme Court of the United States

OCTOBER TERM, 1987

DUQUESNE LIGHT COMPANY
AND
PENNSYLVANIA POWER COMPANY
Appellants,

v.

DAVID M. BARASCH,
CONSUMER ADVOCATE, et al.
Appellees.

On Appeal from the Supreme Court of Pennsylvania

JURISDICTIONAL STATEMENT

ALAN L. REED
WILLIAM E. ZEITER*
JOHN F. STILLMUN, III

MORGAN, LEWIS & BOCKIUS
2000 One Logan Square
Philadelphia, PA 19103
(215) 963-5367

CHRISTINE A. HANSEN
RICHARD S. CHRISTNER
LARRY R. CRAYNE
DUQUESNE LIGHT COMPANY
1 Oxford Centre
301 Grant Street
Pittsburgh, PA 15279

JAMES R. EDGERLY
STEPHEN L. FELD
PENNSYLVANIA POWER COMPANY
1 East Washington Street
New Castle, PA 16103-0891

Attorneys for Duquesne Light Company and Pennsylvania Power Company

January 12, 1988

*Counsel of Record

QUESTIONS PRESENTED

1. Does the Pennsylvania Supreme Court's interpretation of Act 335 and other Pennsylvania ratemaking legislation effect a taking of property in violation of the Fifth and Fourteenth Amendments by precluding the state ratemaking agency from considering constitutionally pertinent factors in determining whether to permit recovery of prudently incurred investment in cancelled electric generating units?

2. Does the Pennsylvania Supreme Court's interpretation of Act 335 and other Pennsylvania ratemaking legislation to deny utility investors any recovery of or on prudently incurred investment in cancelled electric generating units effect a taking of property in violation of the Fifth and Fourteenth Amendments where the state ratemaking agency has concluded that the appropriate balance between investor and consumer interests requires the recovery of such investment?

PARTIES BELOW

In addition to David M. Barasch, Consumer Advocate, the appellants below were Equitable Life Assurance Society, Joseph Horne Company, Kaufmann's and Gimbels. The Pennsylvania Public Utility Commission was the appellee below. Appellants Duquesne Light Company and Pennsylvania Power Company were intervenors below.

STATEMENT OF CORPORATE RELATIONSHIPS

Appellant Pennsylvania Power Company is a wholly owned subsidiary of Ohio Edison Company.

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In The Supreme Court of the United States

OCTOBER TERM, 1987

No.

DUQUESNE LIGHT COMPANY
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PENNSYLVANIA POWER COMPANY
Appellants,

v.

DAVID M. BARASCH,
CONSUMER ADVOCATE, ET AL.
Appellees.

On Appeal from the Supreme Court of Pennsylvania

JURISDICTIONAL STATEMENT

Duquesne Light Company ("Duquesne") and Pennsylvania Power Company ("Penn Power") appeal from the final judgment of the Supreme Court of Pennsylvania, dated October 15, 1987, holding that Act 335, as incorporated in 66 Pa.C.S. § 1315, is not unconstitutional as being violative of the Fifth and Fourteenth Amendments to the Constitution of the United States.

OPINIONS BELOW

The opinion of the Supreme Court of Pennsylvania (App. A) is reported at 532 A.2d 325. The opinion of the Commonwealth Court of Pennsylvania (App. B) is reported at 90 Pa. Cmwlth. 98, 494 A.2d 58. The Opinion and Order of the Pennsylvania Public Utility Commission ("PUC") in Duquesne's case (App. C) is reported at 51 P.U.R.4th 198. The PUC's Opinion and Order Upon Reconsideration in Duquesne's case (App. D) is

reported at 52 P.U.C.4th 644. The PUC's Opinion and Order in Penn Power's case (App. E) is reported at 60 P.U.R.4th 593.

JURISDICTION

The Supreme Court of Pennsylvania entered judgment on October 15, 1987. Duquesne Light Company and Pennsylvania Power Company filed a timely notice of appeal in the Supreme Court of Pennsylvania on January 7, 1988. This appeal is being docketed within 90 days of the date of the judgment below. This Court has appellate jurisdiction under 28 U.S.C. § 1257(2).

CONSTITUTIONAL AND STATUTORY PROVISIONS

United States Constitution, Amendment V, clause 4:

> [N]or shall private property be taken for public use, without just compensation.

United States Constitution, Amendment XIV, clause 3:

> [N]or shall any State deprive any person of ... property, without due process of law....

Act 335, as incorporated into § 1315 of the Pennsylvania Public Utility Code, 66 Pa.C.S. § 1315, and Chapter 13 of the Pennsylvania Public Utility Code, 66 Pa.C.S. §§ 1301–1325, are reprinted in Appendix L. Other pertinent acts amending the Pennsylvania Public Utility Code are summarized in Table A (App. 1m-3m) and are reprinted in Appendix M.

STATEMENT OF THE CASE

During the late 1960s, substantial annual increases in demand for electric power, and the massive New York City and Northeast blackouts, prompted nationwide concern that electric utilities soon would be faced with insufficient generating capacity. In Pennsylvania, the

PUC opened an investigation of a perceived failure on the part of Pennsylvania's jurisdictional electric utilities to begin construction of needed plant additions. *See Investigation of the Need for Additional Electric Generating and Transmission Facilities*, 46 Pa. P.U.C. 23 (1972).

This investigation led the PUC to conclude that "a desperate situation was developing" which could "within the near future ... result in possible blackouts and customer load curtailments." *Id.* at 24. In light of this conclusion, the PUC instructed Pennsylvania's electric utilities "that immediate preparations should be made to increase installed capacity until a reliable reserve of 20% above forecasted loads was reached." *Id. See* App. 13c. *See also, Pennsylvania Public Utility Comm'n v. Metropolitan Edison Co.*, 47 Pa. P.U.C. 56 (1973).[1]

In 1967, Duquesne and Penn Power, along with Ohio Edison Company, The Cleveland Electric Illuminating Company and The Toledo Edison Company, had formed the Central Area Power Coordination Group ("CAPCO"). One of CAPCO's principal objectives was to take advantage of the economies of scale through the joint construction and financing of electric generating facilities. In accordance with this objective, the CAPCO companies, in the early 1970s, authorized the construc-

[1]The following passage from the PUC's Opinion in the *Metropolitan Edison* case illustrates the pressures placed on the electric industry in the late 1960s and early 1970s to expand their generating facilities:

> "This Commission, and other regulatory bodies consider essential the continuing construction of electric generating capacity to meet the energy needs of the public. Respondent and other electric companies in Pennsylvania are continuing heavy expenditures to add additional generating facilities as rapidly as possible to meet adequately the public demand for service. *To protect the public interest*, this Commission has insisted that construction be accelerated and all feasible methods adopted to meet the present emergency." 47 Pa. P.U.C. at 59 (Emphasis added).

tion of seven large nuclear generating units, including Davis-Besse Unit Nos. 2 and 3 and Erie Unit Nos. 1 and 2, which are the four units at issue in this case (the "four CAPCO units"). Thereafter, each of the member CAPCO companies incurred substantial pre-construction expenses relating to the four CAPCO units.

In January of 1980, prior to the issuance by the Nuclear Regulatory Commission of construction permits for the four CAPCO units, CAPCO announced their cancellation. The intervening events which led to this decision are documented at length in Administrative Law Judge Joseph P. Matuschak's Report of Investigation at Dockets I-79070315 and I-79070317 (Pa. P.U.C. October 15, 1982) (App. H) (the "CAPCO Investigation").[2] In summary, Judge Matuschak found that the 1974 recession, the mild summers and winters of 1974 and 1975, and, most importantly, the Arab oil embargo had caused wholly unexpected and unforeseeable changes in the previously consistent pattern of annual growth in electric demand confronting Duquesne and Penn Power. When combined with the accident at Three Mile Island in 1979, these circumstances demanded a re-evaluation of CAPCO's construction program. Because these extraordinary events could not have been predicted, and indeed were directly contrary to the consensus demand for expansion of generating capacity that prevailed in the late 1960s and early 1970s, Judge

[2]The CAPCO Investigation resulted from the PUC's decision in July of 1979 to institute proceedings against Duquesne and Penn Power for the purpose of determining whether recently announced delays in a number of CAPCO sponsored nuclear generating stations, including the four CAPCO units, were justifiable. While that investigation was pending before Judge Matuschak, cancellation of the four CAPCO Units was announced. The CAPCO Investigation thereafter focused upon, *inter alia*, both the prudence of CAPCO's decision to begin construction of these units and the prudence of CAPCO's later decision to cancel them.

Matuschak concluded that CAPCO, and specifically Duquesne and Penn Power, could not be faulted for having embarked on the construction of the four CAPCO units, nor for their decision to cancel those units in 1980. To the contrary, he found that "the CAPCO decisions in regard to the Davis-Besse 2 and 3 and Erie 1 and 2 nuclear units, at every stage to their cancellation, were reasonable and prudent." (App. 19h).[3]

Judge Matuschak then recommended that Duquesne and Penn Power be permitted a recovery *of* their investments in the four CAPCO units over a period of ten years but not be allowed to earn any return *on* the amount of their investment remaining to be recovered during the rest of the period, thereby balancing the burden of this loss between the utilities' shareholders and ratepayers.[4] The PUC agreed and proceeded to allow Duquesne to begin to recover its investment in the four CAPCO units by way of a ten-year amortization in its next rate proceeding, which is the rate proceeding at is-

[3]The PUC by Opinion and Order entered January 13, 1983 adopted the Report of Investigation. (App. li). This order was never appealed. The PUC later explicated its reasoning in its Opinion and Order Upon Reconsideration in the Duquesne case. (App. 9d). In all proceedings below, the prudent nature of the costs at issue has been undisputed.

[4]Judge Matuschak's opinion and the papers in this case contain repeated references to a "return *of*" and a "return *on*" electric plant cancellation costs. The difference between these terms is best explained by example. An investor who provides another with funds, e.g., a financial institution which lends funds to a home buyer, expects repayment in two ways. First, the investor desires ultimately to retrieve his or her initial investment, e.g., by periodic amortization or principal payments equalling the amount originally invested. In utility parlance this is referred to as a "return *of*" or "recovery *of*" the investment, and usually is accomplished through "amortization" or "depreciation" charges. Second, the investor desires to receive compensation for the use of his or her funds by a periodic payment representing a percentage or other yield on the unrecovered balance of the investment. In utility parlance the compensation for use of invested funds is referred to as a "return *on*" the investment.

sue in this case. (App. 35c-37c) The PUC later authorized Penn Power to do the same. (App. 81e-82e).[5]

The PUC's decision in Duquesne's rate case allowing a recovery *of* Duquesne's investment in the four CAPCO units was entered on January 28, 1983. After the record had been closed and the issues briefed, but before the PUC's decision in that case, Act No. 1982-335, P.L. 1473 ("Act 335") (App. 6m-7m) was enacted on December 30, 1982, adding Section 1315 to the Pennsylvania Public Utility Code. *See* 66 Pa.C.S. § 1315. Act 335 was adopted in response to public concern that the PUC might depart from its past practice and allow over $500 million of the costs associated with Philadelphia Electric Company's Limerick nuclear generating station then under construction to be included in rate base prior to completion. (App. 6b-7b). Act 335 effectively prohibited the PUC from doing so and, in this respect, served to confirm the PUC's past practice under which such "construction work in progress" costs ("CWIP") were, except in certain circumstances not relevant here, not permitted to be included in rate base until the underlying project or facility had been placed in service. (App. 13c-13d).[6]

[5]As reflected in the record, Duquesne's claim for such expenses amounted to $34,697,389, before taxes. Penn Power's claim totalled $15,609,628 before taxes. An itemization of total CAPCO expenditures on the four CAPCO units, as submitted by Penn Power to the Federal Energy Regulatory Commission ("FERC") is contained in Appendix J (App. 19j-25j).

[6]A public utility can be compensated in either of two ways for the "time value" of its funds invested in major construction projects with respect to the period between expenditure and completion of the project.

First, the carrying charges on the construction costs may be capitalized as part of the project's historical cost through an "allowance for funds used during construction," (usually abbreviated either AFUDC or AFDC) equal to "the net cost for the period of construction of borrowed funds used for construction purposes and a reasonable rate on" equity used for such purposes. See FERC *Electric Plant Instruction* 3A(17). 18 C.F.R. Part

(footnote continued on next page)

On February 14, 1983, the Pennsylvania Office of Consumer Advocate ("Consumer Advocate") petitioned for reconsideration of the PUC's decision in Duquesne's rate case to allow recovery *of* Duquesne's investment in the four CAPCO units. The Consumer Advocate argued that Act 335 not only prohibited the inclusion of CWIP in rate base, but also prohibited any recovery *of* or *on* investment in cancelled generating units. On April 18, 1983, the PUC issued its Opinion and Order Upon Reconsideration, rejecting the Consumer Advocate's interpretation of Act 335 and affirming its prior ruling. (App. 10d-14d).

In Penn Power's case, the PUC adhered to its decision in Duquesne's case and, by Opinion and Order of April 11, 1984 (App. E), approved rate levels that included Penn Power's expense claim for a recovery, over a ten-year amortization period, *of* (but not a return *on*) its investment in the four CAPCO units.

In its Opinion and Orders of June 13, 1985, the Commonwealth Court affirmed the PUC's decisions in the Duquesne and Penn Power rate cases, holding that Act

101 (1987). This approach reduces the rates of ratepayers during the precompletion period, while correspondingly increasing relative rates during the postcompletion period.

Second, the value of the construction investment can be included in rate base, in the form of CWIP, prior to the completion of construction. Under this approach no AFUDC accrues after the investment is included in rate base. As a result, this approach increases rates during the precompletion period, while correspondingly decreasing relative rates during the postcompletion period. For a further discussion of CWIP and AFUDC, *see generally*, L. Schwartz, J. Flynn & H. First, *Free Enterprise and Economic Organization: Government Regulation* 465-492 (6th ed. 1985).

Consequently, an anti-CWIP statute merely *defers* the timing of the receipt by a utility of a return *of* and *on* its construction investment without adversely affecting the economic value of that investment. Because cancelled plants are never completed, application of an anti-CWIP statute to cancellation costs prevents a utility from *ever* receiving a return *of* or *on* its investment in such costs.

335 was intended only to exclude CWIP from *rate base* and had no applicability to an otherwise proper *expense* reflecting the recovery *of* prudently incurred investment in cancelled electric generating units. (App. 7b-8b).

In a concurring opinion, President Judge Crumlish supplemented the majority's reasoning by observing that the Consumer Advocate's reading of Act 335 would raise "serious constitutional problems" (App. 10b). As had been noted by the Commission below (App. 14d), and as had been argued by Penn Power and Duquesne, such a rule would pose a "real and not fanciful" confiscation issue.

Subsequent to the Commonwealth Court's decision, Act 62, adding § 520 to the Pennsylvania Public Utility Code, 66 Pa.C.S. § 520, was signed into law on October 10, 1985. (App. 19m-20m). The Pennsylvania legislature enacted § 520 in response to public pressure to define the PUC's authority to order the cancellation of electrical generating facilities under construction. In combination with the authority to cancel plants under construction, § 520 authorized the PUC to permit recovery *of* prudently-incurred investment in cancelled generating units by way of amortization without a return *on* the unamortized balance, precisely the result endorsed by the PUC and Commonwealth Court in this case. By its terms, however, § 520 applied only to cancellations effected after October 10, 1985.

The Pennsylvania Supreme Court reversed the Commonwealth Court in an opinion dated October 15, 1987. In that opinion, the Court recognized that the PUC had viewed "its decision to permit recovery through amortization" as

> a discharge of its duty to balance the interests of consumers and utility investors when determining what are "just and reasonable" rates.

532 A.2d at 331 (App. 11a). Nevertheless, the Court rejected the statutory construction analysis of the PUC and the Commonwealth Court, finding that the language of Act 335 was unambiguous on its face and applies to bar amortization or, for that matter, any recovery of utility cancellation costs. The Court then went on to discuss the various constitutional challenges raised by Duquesne and Penn Power.

In addressing the confiscation issue under the Fifth and Fourteenth Amendments to the United States Constitution, the Court cited a multitude of this Court's decisions predating *FPC v. Hope National Gas Co.*, 320 U.S. 591 (1944), but mentioned neither *Hope* nor this Court's more recent elaboration in *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), nor recognized any obligation to balance consumer and investor interests in evaluating the end result of a utility rate order. 532 A.2d at 335-37 (App. 21a-26a). Instead, the Court merely held that the federal constitution's protection extends only to utility property that is "used and useful" and to operating expenses that represent "a cost of providing *present* utility service." 532 A.2d at 336 (App. 25a) (Emphasis in original).[7]

THE QUESTIONS PRESENTED ARE SUBSTANTIAL

This Court for many years has equated the "just and reasonable" standard found in most federal and state

[7]The Pennsylvania Supreme Court also rejected Appellants' equal protection arguments presented below, as well as Appellant Penn Power's constitutional challenge to the Court's interpretation of Act 335 to deny recovery for land held for future use. Appellants have acquiesced in these holdings for the purpose of this case and accordingly the questions presented do not encompass these issues. Appellants have not acquiesced in the Court's holding (App. 27a) that the Fifth and Fourteenth Amendments are not a bar to the retroactive application of Act 335 to investment made *and cancelled* prior to its enactment. However, this issue is moot here in light of the Court's reinterpretation of other Pennsylvania ratemaking legislation so as to make Act 335 merely cumulative. *See* note 9 *infra*.

ratemaking statutes[8] with the minimum constitutional requirement for avoiding the taking of utility investment. *See FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942). In *Hope*, this Court established a balancing test for determining whether rates are "just and reasonable," explaining that the "fixing of 'just and reasonable' rates involves a balancing of the investor and the consumer interests." *Hope*, 320 U.S. at 603. *Hope* also freed reviewing courts of the burden of having to scrutinize rate orders in great detail, as had been required under the "fair value" standard of *Smyth v. Ames*, 169 U.S. 466 (1898). The new approach established in *Hope* did not eliminate constitutional review of rate orders, but merely modified the reviewing court's role from analyzing the fair value of each item of utility property to determining whether the "end result" of the rate order represented a balance between investor and consumer interests.

In *Permian*, this Court elaborated on the role of the judiciary in reviewing the ratemaking process to insure that the statutorily and constitutionally-mandated balancing of interests has taken place. This Court stated:

> the [reviewing] court must determine whether the [rate] order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable. The court's responsibility is not to supplant the Commission's balance of these interests with one more nearly to its liking, but instead to assure itself that the Commission has given *reasoned consideration to each of the pertinent factors.*

[8] *See, e.g.*, Federal Power Act, 16 U.S.C. § 824d(a), and the Natural Gas Act, 15 U.S.C. §§ 717c(a), 717d(a).

> Judicial review of the Commission's orders will therefore function accurately and efficaciously only if the Commission indicates fully and carefully the methods by which, and the purposes for which, it has chosen to act, as well as its assessment of the consequences of its orders for the character and future development of the industry.

Permian, 390 U.S. at 792 (emphasis added).

In this case, the Pennsylvania Supreme Court completely ignored its obligations under *Hope* and *Permian*. The PUC below had given reasoned consideration to each of the pertinent factors as contemplated by *Permian*, and had issued a rate order that carefully balanced investor and consumer interests as required by *Hope*. Although it paid lip-service to the PUC's balancing effort, the Court, through its interpretation of Act 335 and other Pennsylvania ratemaking legislation,[9] obliterated the balance struck by the PUC. In doing so, the Court made no effort to determine whether under its construction of the applicable state law "each of the pertinent factors" identified in *Permian* could be considered, or whether the Duquesne and Penn Power rate orders, in the absence of the recovery of cancellation costs, reflected a proper balance of investor and consumer interests as required by *Hope*. Instead, the Court leaped backwards over *Hope* and *Permian* to resurrect isolated statements from *Smyth* and its progeny. The

[9] The Pennsylvania Supreme Court's wholly unnecessary reinterpretation of unspecified portions of the ratemaking provisions of the Pennsylvania Public Utility Code, so as to render Act 335 consistent with a general principle that no utility may *ever* recover its investment in cancelled facilities (thereby avoiding Appellants' equal protection arguments advanced below), renders the entire ratemaking chapter of the Code at issue in this case. Consequently, Appellants have printed all of Chapter 13 of the Code (relating to rates and ratemaking) in Appendix L. Throughout this Jurisdictional Statement, Appellants refer to the statutes at issue as "Act 335 and other Pennsylvania ratemaking legislation."

Court sought to justify the constitutionality of its statutory interpretation by holding that only "used and useful" property is entitled to constitutional protection.

The Pennsylvania Supreme Court's decision results in a rate order that is unfair to utility investors. The questions presented in this appeal address the procedural and substantive constitutional implications of this unfair end result. The answer to these questions has nationwide significance.

In the years following the Arab oil embargo, energy price inflation has produced a substantial decline in the rate of growth of consumer demand for electricity. At the same time, the cost of constructing the many large electric generating facilities planned during the decades of high growth in electricity demand have skyrocketed. When faced with requests for rate increases to compensate utility investors for their massive investment in completed plants, and their substantial investment in plants cancelled prudently in face of declining demand, state regulators, state courts and state legislatures have experienced significant public pressure to limit the growth of electric rates.[10] As a result, many such regulators, courts and legislatures have manipulated traditional ratemaking principles in an effort to minimize the

[10]The post-1973 Pennsylvania statutory changes (see Table A, App. 1m-4m) are graphic evidence of these pressures. *See, e.g.*, Act No. 1986-114 (§ 321), which requires an annual report by the Governor to the Pennsylvania Legislature. (App. 26m-27m). The report is required to contain a summary of all rate proceedings completed by the Pennsylvania Commission within the reporting period, the amount of the rate increase requested in each such proceeding, the amount of the request granted by the Commission in each such proceeding, and the percentage increase in rates requested and granted in each such proceeding as compared to the percentage increase requested and granted in the most recent similar proceeding for the affected utility prior to the reporting period. The statute does not similarly mandate reporting on the status of or adequacy in the allowed and achieved return *of* or *on* the utility's investment.

resulting rates. These result-oriented actions often produce state rate orders that test the limits of constitutional takings.

Unfortunately, rather than recognize the serious constitutional implications of their actions, state courts have increasingly ignored the principles this Court articulated in *Hope* and *Permian*. Although some state courts recognize that constitutional limitations still govern the extent to which a state may deny utility investors a recovery of prudently incurred costs,[11] other state courts have permitted[12] or denied[13] recovery *of* or *on*

[11]*See e.g., People's Organization v. Washington Utilities & Transp. Comm'n*, 711 P.2d 319 (Wash. 1986); *State ex rel. Union Elec. Co. v. Public Service Comm'n*, 687 S.W.2d 162 (Mo. 1985). When presented with essentially the same statute and facts as involved in this case, the Missouri Supreme Court in *Union Electric* recognized the serious constitutional infirmities in extending an anti-CWIP statute to cancellation costs, and, unlike the Pennsylvania Supreme Court in this case, adopted a limited statutory construction similar to that of the PUC and Commonwealth Court below.

[12]*See, e.g., Attorney General v. Department of Public Utilities*, 390 Mass. 208, 455 N.E.2d 414 (1983) (collecting cases); *Wisconsin Public Service Corp. v. Public Service Comm'n*, 109 Wisc.2d 256, 325 N.W.2d 867 (1982); *Central Maine Power Co. v. Public Utilities Comm'n*, 433 A.2d 331 (Me. 1981).

[13]This Court previously has been asked to review state rate orders from Ohio and Indiana that denied recovery of prudently incurred investment in cancelled plants. *See Northern Indiana Public Service Co. v. Citizen's Action Coalition of Indiana, Inc.*, 485 N.E.2d 610 (1985), *appeal dismissed and cert. denied*, 106 S.Ct. 2239 (1986) ("NIPSCO"); *Cleveland Elec. Illuminating Co. v. Public Utilities Comm'n*, 4 Ohio St. 3d 107, 447 N.E.2d 746, *appeal dismissed*, 464 U.S. 804 (1983) (dismissed for want of a substantial federal question) ("*CEI*"). *See also Office of Consumers' Counsel v. Public Utilities Comm'n*, 67 Ohio St. 2d 153, 423 N.E.2d 820 (1981), *appeal dismissed*, 455 U.S. 914 (1982) (dismissed for want of a properly presented federal question); *Cleveland Elec. Illuminating Co. v. Public Utilities Comm'n*, No. 82-165 (Ohio, July 7, 1982), *appeal dismissed*, 459 U.S. 1094 (1983) (dismissed for want of a properly presented federal question). Although *CEI* involved Ohio's treatment of the same four CAPCO units at issue in this case, the utility did not seek review on the issue of *Hope's* balancing test and *Permian's* standard of review. And, of course, *CEI* did not involve the statutory issues discussed *infra* specific to Pennsylvania. This Court "has repeatedly stated

(Footnote continued on following page)

such costs with little regard for the constitutional implications. The reluctance of state courts to engage in meaningful constitutional review of rate orders is likely the result of their substantial uncertainty over the meaning of *Hope* and *Permian*, combined with a perception that their decisions, regardless of the end result, are effectively insulated from federal review.[14] This is not surprising. Next term will mark the 50th anniversary of *Driscoll v. Edison Light and Power Co.*, 307 U.S. 104 (1939), the last state fixed service rate order reviewed by this Court. Indeed, as the hiatus in federal review has matured into a half century of desuetude, one state supreme court has actually been moved to declare that "[t]he federal constitution no longer provides any special protections for utility investors." *Dayton Power Co. v. Public Utilities Comm'n*, 4 Ohio St.3d 91, 447 N.E.2d 733 (1983).

The state courts are not alone in their confusion over the meaning of *Hope* and *Permian*. Even federal regulators and the federal judiciary appear to be in a quandary over how to interpret and apply *Hope's* balancing test and *Permian's* standard of review. Nowhere is this federal misunderstanding more evident than in the in-

(Footnote continued from previous page)
that although summary dispositions are decisions on the merits, the decisions extend only to 'the precise issues presented and necessarily decided by those actions.' " *Metromedia, Inc. v. City of San Diego*, 453 U.S. 490 (1981) (quoting *Mandel v. Bradley*, 432 U.S. 173 (1977)). Moreover, this Court has often given plenary consideration of the merits of a case, rather than rely on an earlier summary disposition. *See e.g., Bowers v. Hardwick*, 106 S.Ct. 2841, 2843, n. 4 (1986). *NIPSCO* did present the *Hope* balancing issue for this Court's review, but the *NIPSCO* appeal had to be dismissed because the utility had failed to preserve its constitutional issues below.

[14]The Johnson Act, 28 U.S.C. § 1342 (1984), prohibits the lower federal courts from reviewing state ratemaking decisions. Consequently, this Court is the only federal forum available for resolving constitutional infirmities in state rate orders.

credibly divergent interpretations advanced by the utility, the FERC, the FERC's own counsel, the majority opinion, the concurring opinion and the dissent in *Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168 (D.C. Cir. 1987) (en banc), itself a cancellation cost case.[15] The wide gulf separating these interpretations makes clear that age has heavily obscured the contemporary meaning of *Hope* and *Permian*, even in their original federal context. Therefore, there is a critical need for this Court's guidance to courts and regulators at all levels in understanding and applying *Hope* and *Permian* and in confirming their continuing viability. The present case presents this Court with the opportunity to provide such guidance.

[15]*Jersey Central* involved a utility's claim for rate base treatment of (i.e., return *on*) the unamortized portion of its cancellation costs. Consistently with its practice, *see e.g., NEPCO Municipal Rate Comm'n v. FERC*, 668 F.2d 1327 (D.C. Cir. 1981), *cert. denied*, 457 U.S. 1117 (1982), FERC had summarily permitted recovery through amortization *of* the cancellation costs, but no return *on* the unamortized balance. The utility, citing *Hope*, sought a return *on* the unamortized balance because its financial position otherwise would be impaired. The FERC initially took the position that a court reviewing its order had little, if any, role to perform. *See* 810 F.2d at 1175 (App. 15k). Before the en banc panel of the District of Columbia Circuit, FERC's counsel argued that a reviewing court could set aside a rate order only where the order would put the utility into bankruptcy. *Id.* (App. 15k). The majority read *Hope* to require a hearing where the utility alleges that the rate order would produce financial hardship. *Id.* at 1175-1182 (App. 14k-30k). The concurring opinion treated *Hope* as requiring that a balancing of investor and consumer interests be performed, in the first instance, by rate regulators and treated the ultimate object of the ratemaking process as seeking to reach a "just result," and thus concurred in remanding the case for a hearing. *Id.* at 1188-1194 (App. 43k-57k). The dissent suggested that the FERC's practice of permitting recovery *of* but denying a return *on* investment in cancelled plants constituted an appropriate balancing of interests such that no further hearing was required. *Id.* at 1194-1215 (App. 57k-107k). It is noteworthy that neither FERC nor the dissent (authored by Mikva, J.) ever suggested that a utility be denied recovery *of* its investment in cancelled plants. Indeed, it bears emphasizing that the dissenters recognized that FERC's practice (to which the PUC conformed below) represents an appropriate balancing of interests. *See* 810 F.2d at 1211-12 (App. 98k-99k).

In the absence of meaningful guidance, state regulators and legislatures have tested the boundaries of constitutional takings in a number of different ways. At the operative level of ratemaking, state regulators have exercised their considerable discretion by employing ratemaking principles that limit recovery of utility investment without regard to the balancing of interests required by *Hope* and *Permian*.[16] At the policy level of ratemaking, state legislatures, by way of statute, have attempted to limit a state regulator's discretion to consider certain utility costs or investments relevant to determining a proper balance between investor and consumer interests. Indeed, as reflected in the present case, Pennsylvania is a jurisdiction that has adopted this latter approach. Since the Arab oil embargo, Pennsylvania has effected more than 20 statutory modifications or amplifications to its basic "just and reasonable" rate-

[16]Just last term, this Court was presented with a constitutional challenge to a state commission's use of a new valuation method which denied a return *on* (but not recovery *of*) much of a utility's investment in a completed nuclear power plant without accounting for the balance of ratepayer and investor interests. *See Kansas Gas & Elec. Co. v. State Corp. Comm'n*, 232 Kan. 483, 720 P.2d 1063 (1986), *probable jurisdiction noted*, 107 S.Ct. 1281, *appeal dismissed*, 107 S.Ct. 2171 (1987); *Kansas City Power & Light Co. v. State Corp. Comm'n*, 232 Kan. 483, 720 P.2d 1063 (1986), *probable jurisdiction noted*, 107 S.Ct. 1281, *appeal dismissed*, 107 S.Ct. 3280. However, after this Court had noted probable jurisdiction, the *Kansas* cases were dismissed without a substantive decision on the *Hope* issue. In the *Kansas Gas & Elec.* case, this Court dismissed the *Hope* question as having been rendered moot, and dismissed the utility's equal protection challenge for want of a substantial federal question. *See* 107 S.Ct. 2171. The *Kansas City Power & Light* case was dismissed by agreement of the parties pursuant to Rule 53 of this Court's Rules. *See* 107 S.Ct. 3280. In the *Kansas* cases, the utilities were concerned with the depressed level of the authorized return *on* their investment, but they at least were entitled to a *complete* recovery *of* their investment through annual depreciation charges. Here Appellants have claimed *no* return *on* their investment, and have been denied *any* recovery *of* their investment. Therefore, this case provides an even more compelling opportunity to address the contemporary meaning of *Hope* and *Permian*.

making rules. *See* Table A (App. 1m-4m). These range from the conventional[17], through a series of acts tinkering with various details of the ratemaking process[18], to attempts to affect particular pending proceedings.[19]

This case involves an extreme example of such manipulation. It presents the question, not previously given plenary consideration by this Court, whether a state may prohibit *any* consideration of selected constitutionally pertinent facts in fixing utility rates. Because the Pennsylvania Supreme Court disregarded the guarantees of the Fifth and Fourteenth Amendments in construing the Pennsylvania statutes at issue, and because federal and state courts and agencies across the country

[17]E.g., Acts Nos. 1984-153 and 240, transferring Pennsylvania from a fair value to an original cost (prudent investment) ratemaking jurisdiction.

[18]E.g., mandating a shared benefit procedure to encourage use of coal (§ 514); permitting consideration of adequacy of service in fixing rate levels (§ 523); permitting use of future test years (§ 524); requiring consideration of savings from cogeneration (§ 527); permitting recovery of costs associated with conservation or load management programs (§ 1319); prohibiting consideration of certain advertising costs (§ 1316), membership fees in fraternal, social or sports clubs (§ 1316.1), certain personal costs associated with conferences or other events (§ 1321) and certain costs related to outages (§ 1322); and requiring certain amounts to be disallowed on account of excess capacity (§ 1323(a)). The text of these statutes appears in Appendix M (App. 5m-36m).

[19]E.g., refunds with respect to coal purchases in 1974 (Act No. 1976-226); exclusion of costs related to cancelled plants and exclusion of CWIP (Act No. 1982-335 (§ 1315) (the statute involved in the instant case), applicable to all cases pending before the PUC or the courts); status of initial cost estimates of large electric generating units (Act No. 1984-123 (§ 1308(f)), retroactive to beginning of construction of pending units); recovery of prudent costs associated with cancelled electric generating units (Act No. 1985-62 (§ 520), applicable to units cancelled after October 10, 1985); expense reductions for 1986 as compared with 1985 (Act No. 1986-114 (§ 522)); rejection of rates where quality of service is inadequate (Act No. 1986-114 (§ 526), applicable to all cases pending before the PUC or the courts); and exclusion of costs of new unit which is out of service at date rate case decided (Act No. 1986-114 (§ 1323(b)), applicable to all cases pending before the PUC). The text of these statutes appears in Appendix M (App. 5m-36m).

are hopelessly divided over the Constitution's requirements in the area of public utility rate regulation, the questions presented here are substantial and warrant plenary review.

I. A State Legislature May Not Preclude A Ratemaking Agency From Considering Factors Pertinent To The Balance Between Investor And Consumer Interests

Historically, state ratemaking commissions were formed to relieve legislatures of the cumbersome task of setting rates by legislation. In delegating legislative tasks to ratemaking agencies, the separation of powers principle has long required that the legislature provide minimum standards to define the duties and powers of the delegatee. *See e.g. A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935). On the other hand, where the ratemaking decisions of the agency can have constitutional implications for private parties, the agency must be invested with discretion sufficient to conform its decisions to constitutional mandates. The lesson of *Hope* and *Permian* is that rate orders must reflect a balance of investor and consumer interests in order to avoid a taking of property without just compensation. Consequently, a necessary corollary of the *Hope* balancing test is that a state ratemaking agency must possess under state law sufficient discretion within the boundaries of its ratemaking authority to balance investor and consumer interests and thereby produce a constitutional end result. In short, *Hope* and *Permian* require that the one who sets rates must balance.[20]

Permian makes it clear that *Hope's* "end result" test does not eliminate entirely the need for a reviewing

[20]In concept, this principle is not unlike the familiar administrative law principle developed from notions of due process that "the one who decides must hear." *See Morgan v. United States*, 298 U.S. 468, 481 (1936).

court to scrutinize the ratemaking process. Although states are free to select among a wide variety of regulatory methods, the method selected must be coherent. *Permian* requires that the ratemaking agency articulate "fully and carefully the methods by which, and the purposes for which, it has chosen to act," and assess the consequences of its action on the balance between investor and consumer interests. 390 U.S. at 792. As the United States Court of Appeals for the District of Columbia Circuit recognized shortly after *Hope*, courts may reject ratemaking formulas that produce an arbitrary end result. *See Mississippi River Fuel Corp. v. FPC*, 163 F.2d 433, 439 (D.C. Cir. 1947). Indeed, this Court has stated that "it is much easier to reject formulas as being misleading than to find one apparently adequate." *Colorado Interstate Co. v. FPC*, 324 U.S. 581, 590 (1945) (quoting *Groesbeck v. Duluth, S.S. & A. RY.* 250 U.S. 607, 614 (1919)).

States are also free to exclude all consideration of factors that are not pertinent to the coherent method selected. *Hope's* approval of the exclusion of fair value rate base evidence in the context of a prudent investment system is itself the quintessential example of the application of this rule. In recent years, however, Pennsylvania has strayed from a coherent "original cost" methodology by passing legislation designed to remove entirely from the Commission's consideration certain types of utility investments. The Commission is thus deprived of hearing all of the factors pertinent to a fair balancing of interests. Moreover, this legislation is sometimes enacted without regard for how it affects the balance between investor and consumer interests in the cases before the PUC, or worse, with an eye to predetermining the outcome of pending cases. In short, the

legislature has attempted through a hodge-podge of special ratemaking rules to place its heavy finger selectively on the balance between investor and consumer interests without itself undertaking the full analysis of pertinent factors required by *Hope* and *Permian*.

The lack of coherence inherent in the present Pennsylvania ratemaking process is apparent from the interplay of Act 335 and the subsequently enacted § 520 of the Pennsylvania Public Utility Code. *Compare* 66 Pa.C.S. § 1315 *with* 66 Pa.C.S. § 520. Section 520 permits amortized recovery *of* (but not a return *on*) the prudently incurred costs of cancelled electrical generating plants. But § 520 applies by its terms only to cancellations effected after October 10, 1985, a date conveniently subsequent to the well-known January 22, 1980 cancellation date of the four CAPCO units. Consequently, the effect of the Pennsylvania Supreme Court's interpretation of Act 335 and related state law is to render the costs at issue in this case the *only* investment in cancelled electric generating stations that is barred by Act 335.

The striking feature of the Pennsylvania Supreme Court's opinion is its total failure to recognize any duty to seek to mold this disparate mass of state legislation into a coherent process ensuring that the end result of ratemaking in Pennsylvania will be fair to both investors and consumers. Instead, the Court endorsed the manipulative Pennsylvania legislative process, without recognizing a duty to balance. At minimum, due process requires that the PUC hear and consider the factors pertinent to a fair balancing between investor and consumer interests. As interpreted by the Pennsylvania Supreme Court, Act 335 and other Pennsylvania ratemaking legislation require the PUC to ignore entirely

the factors pertinent to the balance of interests with respect to a utility's prudent investment in cancelled power plants. These statutes, therefore, are unconstitutional on their face.

II. The Balancing of Consumer and Investor Interests In This Case Requires Recovery of Prudently Incurred Investment in Cancelled Electric Generating Units

The Pennsylvania Supreme Court's failure to discharge its responsibility under *Hope* and *Permian* to examine the balance of investor and consumer interests results in a taking of the utility shareholders' investment without compensation. The appropriate balance of interests in this case requires at minimum that the shareholders of Duquesne and Penn Power recover their costs prudently invested in the four CAPCO units. A complete denial of any recovery produces rates that are not "just and reasonable," and, therefore, are unconstitutional.

The appropriate balance of interests in this case is reflected in the PUC order below. The PUC found that the shareholders' investment in preconstruction costs of the four CAPCO units was prudently incurred. Indeed, such investments were undertaken at the strong urging of the PUC because of the desperate need for expansion of electric generating capacity, and were consistent with the utilities' statutory duty to provide electrical service to consumers. See 66 Pa.C.S. § 1501. Thus, *consumer* interests supported, if not mandated, incurring the costs at issue.

Simple fairness dictates that the shareholders, having been requested and required to make substantial investments in generating facilities for the public interest,

must recover at minimum the funds they have prudently invested.[21] The PUC recognized this principle, and, in the belief that Act 335 did not apply, permitted the shareholders to recover the amounts they had invested, without recovering interest or any other return on their investment. Under this approach the shareholders do not profit from their investment, but also are not forced to bear the risk of the entire loss.[22]

The PUC was not alone in striking this balance. Indeed, this balance is consistent with FERC practice, *see Jersey Central*, 810 F.2d at 1172[23]; *NEPCO*, 668 F.2d at 1332-35, and FERC specifically approved recovery, through amortization, *of* the costs at issue here. (App. 1j-18j).

[21]It should be noted that, because of its arbitrary nature, the Pennsylvania Supreme Court's "heads the consumer wins, tails utility investors lose" interpretive approach and its acceptance of the incoherent interaction between § 520 and § 1315 (*see* p. 20 *supra*) do not even satisfy the existing standards for testing state economic regulation generally under the Fourteenth Amendment. *See generally Nebbia v. New York*, 291 U.S. 502, 525 (1934) and its progeny (requiring that economic regulation not be arbitrary or irrational).

[22]Even this result would not produce a complete economic retrieval of the shareholders' investment, because the denial of a return *on* the unamortized balances during the ten-year amortization period would take from the utility investors the time value of their invested funds. The effect of the "balance" struck by the Commission is to require the utility investors to provide consumers with what amounts to an interest-free loan. The economic effect of lengthening the amortization period can be dramatic. During the CAPCO investigation, the Administrative Law Judge recognized that Appellant Duquesne (App. 19h-20h):

> has paid its costs in connection with the cancelled plants for the past eight years, and will continue to do so over the next ten years. The investors will pick up more than 50% of the associated costs even if the Company's claim [for recovery *of* such costs] is paid in full.

[23]In *Jersey Central*, even the dissenters recognized the necessity of providing a recovery to utility shareholders:

> Under price regulations, which affords the utility a "natural monopoly" on service, some of the risk at either end of the spectrum is shift-

(footnote continued on next page)

Recovery *of* their investment thus is necessary "to compensate investors for the risks they have assumed." *Permian Basin*, 390 U.S. at 792. Indeed, the concept of balancing public and private interests appears throughout this court's constitutional takings analysis. In non-utility takings cases, this Court often has balanced the public interest in the property at issue with "reasonable, investment-backed expectations." *Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979).[24] In such cases, moreover, this Court has found confiscatory takings where the economic value of the property at issue was substantially below the absolute and proportional value of Duquesne's and Penn Power's investment in the cancelled plants at issue here.[25]

> ed onto the ratepayer. The transfer, however, is not so dramatic as to relieve the stockholder of the entire risk of loss.
>
> Application of this principle is readily apparent in the Commission's current treatment of electric utility plants, investments prudent when made but sometimes frustrated in fruition. If the investment is successful, the customer benefits from controlled rates for the service provided. But the ratepayer also shares the costs if the investment fails; he must pay for the expenditure made on an unproductive facility from which he obtains no service. From the investor's viewpoint, price regulation cabins both his upside and downside risk. He cannot collect the windfall benefits if the project is a boon; he does not bear all costs if the project is a bust. Electric utility stockholders do not lose equity in the non-serviceable facility, as they might in the marketplace. They simply do not procure a return on the investment.

810 F.2d at 1211-12 (Mikva, J., dissenting) (App. 98K-99K).

[24]*See e.g., Ruckleshaus v. Monsanto Co.*, 467 U.S. 986 (1984) (Federal regulation requiring disclosure of data effected a taking of pesticide company's investment-backed expectation of confidentiality in certain pesticide secrets); *Kaiser*, 444 U.S. at 179-80 (government imposition of navigational servitude effected a taking of petitioners' investment-backed expectation of their right to exclude which was based on their reasonable reliance on government's consent to connect private pond to navigable waters). Indeed, the landowner's reliance on governmental consent to the navigational channel at issue in *Kaiser* is comparable to the reliance of Duquesne and Penn Power on PUC mandates in undertaking to increase their generating capacity herein.

[25]*See e.g., Nollan v. California Coastal Comm'n*, 107 S.Ct. 3141 (1987) (conditioning landowners' rebuilding permit on granting of public easement

(Footnote continued on following page)

Prior to the enactment of Act 335, there was no suggestion in Pennsylvania that recovery of cancellation costs through amortization would produce exploitive rates. Moreover, federal courts have long recognized that utilities are entitled to recover amounts invested in prudently incurred expenses, including engineering expenses similar to those involved in this case. *See Mississippi River Fuel*, 163 F.2d at 438 (referring to engineering costs). The court in *Mississippi River Fuel* recognized that it was confiscatory for a ratemaking agency to deny recovery of prudently incurred expenses.[26] This is particularly so where historic federal and state treatment of prudently incurred expenses induces the legitimate investment-backed expectation that such expenses are recoverable.[27] When such expenses are denied, particularly where, as here, the record does not contain substantial countervailing consumer interests, the balance between investor and consumer interests is de-

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along narrow strip of beach at periphery of property constituted a taking); *see also Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 (1982) (cable installation on appellant's building constituted a taking). Although *Loretto* involved a per se rule for "permanent physical invasion" of property, it is noteworthy that the actual space occupied may have been only slightly in excess of one and one-half cubic feet. In this case, the effect of the judgment below is to permanently deprive Appellants of the substantial funds expended on the four CAPCO units.

[26]As the District of Columbia Circuit recognized in *Mississippi Fuel*:

> Expenses (using that term in its broad sense to include not only operating expenses but depreciation and taxes) are facts. They are to be ascertained, not created, by the regulatory authorities. If properly incurred, they must be allowed as part of the composition of the rates. Otherwise, the so-called allowance of a return upon the investment, being an amount over and above expenses, would be a farce.

163 F.2d at 437.

[27]As late as 1982, the "overwhelming weight of authority" supported recovery *of* prudently incurred investment in cancelled plants. (App. 11h).

stroyed and the resulting rates become unconstitutionally confiscatory.

Hope and *Permian* are grounded in the theories of utility ratemaking contained in J. Bonbright, *Valuation of Property* (1937). Bonbright was at the forefront of developing the notion that a ratemaking agency need not employ any particular methodology, as long as the method employed is applied consistently. Bonbright was also aware that principles of "fair play" require that when changes are made to ratemaking methodologies the costs borne and rewards received by investors and consumers be related to their expectations and the risks they have assumed. *See* 2 J. Bonbright, *Valuation of Property* 1155 and n.113 (1937).

The Pennsylvania Supreme Court's decision in this case does violence to the reasonable expectations of utility investors and saddles them with risks that they did not voluntarily assume, without articulating a countervailing consumer interest. Denial of any recovery *of* the costs prudently invested in the four CAPCO units effects an unconstitutional taking of the investors' property.

CONCLUSION

The Court should note probable jurisdiction.

Respectfully submitted,

ALAN L. REED
WILLIAM E. ZEITER*
JOHN F. STILLMUN, III

MORGAN, LEWIS & BOCKIUS
2000 One Logan Square
Philadelphia, PA 19103
(215) 963-5367

CHRISTINE A. HANSEN
RICHARD S. CHRISTNER
LARRY R. CRAYNE
DUQUESNE LIGHT COMPANY
1 Oxford Centre
301 Grant Street
Pittsburgh, PA 15279

JAMES R. EDGERLY
STEPHEN L. FELD
PENNSYLVANIA POWER COMPANY
1 East Washington Street
New Castle, PA 16103-0891

Attorneys for Duquesne Light Company and Pennsylvania Power Company

January 12, 1988

*Counsel of Record

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87-1160

No.

In The Supreme Court of the United States

OCTOBER TERM, 1987

DUQUESNE LIGHT COMPANY
AND
PENNSYLVANIA POWER COMPANY
Appellants,

v.

DAVID M. BARASCH,
CONSUMER ADVOCATE, ET AL.
Appellees.

On Appeal from the Supreme Court of Pennsylvania

APPELLANTS' APPENDIX TO JURISDICTIONAL STATEMENT

ALAN L. REED
WILLIAM E. ZEITER*
JOHN F. STILLMUN, III

MORGAN, LEWIS & BOCKIUS
2000 One Logan Square
Philadelphia, PA 19103
(215) 963-5367

CHRISTINE A. HANSEN
RICHARD S. CHRISTNER
LARRY R. CRAYNE
DUQUESNE LIGHT COMPANY
1 Oxford Centre
301 Grant Street
Pittsburgh, PA 15279

JAMES R. EDGERLY
STEPHEN L. FELD
PENNSYLVANIA POWER COMPANY
1 East Washington Street
New Castle, PA 16103-0891

Attorneys for Duquesne Light Company and Pennsylvania Power Company

*Counsel of Record

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APPENDIX A

Opinion of the Pennsylvania Supreme Court

David M. BARASCH,

Consumer Advocate,

v.

PENNSYLVANIA PUBLIC UTILITY COMMISSION.

Appeal of EQUITABLE LIFE ASSURANCE SOCIETY, Joseph Horne Company, Kaufmann's and Gimbels.

David M. BARASCH, Consumer Advocate, Appellant,

v.

PENNSYLVANIA PUBLIC UTILITY COMMISSION.

Supreme Court of Pennsylvania.

Argued March 11, 1987.
Decided Oct. 15, 1987.

[Summary by West Publishing Co.]

Pennsylvania Office of Consumer Advocate appealed from final order of the Public Utility Commission, which permitted inclusion of costs of construction for cancelled nuclear plans in electric company's rate base. The Commonwealth Court, No. 553 C.D. 1983, and No. 1364 C.D. 1984, Barry, J., 90 Pa.Cmwlth. 98, 494 A.2d 58, affirmed in part and reversed in part. The Office of Consumer Advocate petitioned for allowance of appeal. The Supreme Court, No. 33 W.D. Appeal Docket 1986, No. 34 W.D. Appeal Docket, 1986, Nix, C.J., held that: (1) electric utilities were prohibited from recovering costs of cancelled nuclear plans from ratepayers, either by making such costs part of their rate base or by converting them into operating expenses through amortiza-

tion; (2) vacant real estate owned by utility, which might not be developed by utility for next ten years, could not be included in its rate base; (3) statute, which prohibited electric utilities from recovering costs of cancelled plans from ratepayers, did not result in unconstitutional confiscation of utilities' property; (4) statute did not violate constitutional provision, requiring that bill's subject be clearly expressed in its title; and (5) statute did not violate electric utilities' right to equal protection of law.

Reversed and remanded.

OPINION

NIX, Chief Justice.

Before us are two consolidated appeals questioning the right of a public utility to recover certain costs from its ratepayers. We are called upon to decide whether section 1315 of the Public Utility Code ("Code"), 66 Pa.C.S. § 1315, bars an electric utility from amortizing costs incurred in connection with plant-construction projects which were cancelled prior to completion, and whether, if the statute must be so read, it violates constitutional safeguards. We must also determine whether vacant land, purportedly held by a utility company "for future use," is properly includible in its rate base.

In 1973 the Central Area Power Coordinating Group ("CAPCO"), a group of various electric utility companies,[1] formulated a plan to construct seven nuclear electric plants. By 1977, despite considerable public opposition, CAPCO had forged ahead with the construction projects. In 1979 the Pennsylvania Public Utility

[1]The members of CAPCO were: Duquesne Light Company, Pennsylvania Power Company, Cleveland Electric Illuminating Company, Ohio Edison and Toledo Edison.

Commission ("Commission"), on its own motion, began an investigation of the CAPCO program because of delays and other construction problems that were afflicting the projects. In January of 1980, about six months after the Commission had begun its investigation, CAPCO announced that construction would be cancelled on four of the seven nuclear plants.[2] The reasons assigned for that decision included: growing political and regulatory uncertainties arising from the nuclear accident at Three Mile Island, serious financial constraints of various CAPCO members, and a reduced need for additional future generating capacity.

The Duquesne Light Company ("Duquesne") had joined CAPCO in 1967, and was a substantial participant in the group's plant construction venture. Duquesne's share of the construction costs of the four cancelled plants was $34,697,389. In 1980, after the cancellation, Duquesne instituted rate proceedings before the Commission; and thereby sought the right to amortize, over a ten-year period, the construction costs it had borne with respect to the four plants. The same request was made in 1981. However, in each of those rate proceedings the Commission deferred ruling on the request until it received a report relative to its ordered investigation of CAPCO's construction problems.

In April 1982 Duquesne again came before the Commission. This time the company filed a tariff which proposed a change in its rates to increase its annual electric revenues by more than $165,000,000. In conjunction, the utility once more sought to amortize its expenditures on the cancelled plant projects. Several parties appeared in opposition to Duquesne's request, including

[2]The four cancelled projects were: Davis-Besse Units 2 and 3; and Erie Units 1 and 2.

the Office of the Consumer Advocate and several commercial complainants.[3] On October 15, 1982, during the pendency of the proceedings last mentioned, an Administrative Law Judge ("ALJ"), Joseph P. Matuschak, filed with the Commission the awaited investigation report.

The ALJ's "Report of Investigation" set forth his findings and recommendations concerning the CAPCO projects and Duquesne's participation therein. Among his determinations were the following: (1) that Duquesne acted prudently in joining in the ownership of the nuclear plants; (2) that the decision to delay until 1980 the cancellation of the four plants in question was prudent; and (3) that the interim decisions regarding the cancelled plants were prudent. In light of these findings or conclusions, ALJ Matuschak recommended that the Commission allow Duquesne to amortize, in rate proceedings over a period of ten years, its share of the construction costs of the four cancelled units. That recommendation, if accepted, would permit Duquesne to include in its reported operating expenses an additional $3,469,739 for each of the ten years of amortization.

On December 30, 1982, while the Duquesne rate case was still before the Commission, Act No. 335, P.L. 1473, was enacted into law. That statute amended the Public Utility Code by adding thereto section 1315. In parts here pertinent, the text of Act No. 335 is as follows:

AN ACT

Amending Title 66 (Public Utilities) of the Pennsylvania Consolidated Statutes, providing *a limitation on the consideration of certain costs in the rate base* for electric public utilities.

[3] Equitable Life Assurance Society, Joseph Horne Company, Kaufmann's, and Gimbels.

The General Assembly of the Commonwealth of Pennsylvania hereby enacts as follows:

Section 1. Title 66, act of November 25, 1970 (P.L. 707, No. 230), known as the Pennsylvania Consolidated Statutes, is amended by adding a section to read:

§ 1315. Limitation on consideration of certain costs for electric utilities.

Except for such nonrevenue producing, nonexpense reducing investments as may be reasonably shown to be necessary to improve environmental conditions at existing facilities or improve safety at existing facilities or as may be required to convert facilities to the utilization of coal, *the cost of construction or expansion of a facility* undertaken by a public utility producing, generating, transmitting, distributing or furnishing electricity *shall not be made a part of the rate base nor otherwise included in the rates charged by the electric utility until such time as the facility is used and useful in service to the public.* Except as stated in this section, no electric utility property shall be deemed used and useful *until it is presently providing actual utility service to the customers.*

Section 2. This act shall be applicable to *all proceedings pending before the Public Utility Commission and the courts at this time.* Nothing contained in this act shall be construed to modify or change existing law with regard to rate making treatment of investment in facilities of fixed utilities other than electric utilities.

Section 3. *This act shall take effect immediately.*

APPROVED—The 30th day of December, A.D. 1982.

(Emphasis added.)

On January 28, 1983, almost one full month after the enactment and effective date of the above statute, the Commission entered an order which accepted the

recommendation of the ALJ concerning the ten-year amortization of Duquesne's portion of the construction costs of the four cancelled electric plants. The Commission's order thus meant that in the rate proceeding then before it, and for nine additional years, Duquesne could include in its reported operating expenses a one-tenth amortization charge of $3,469,739. The Commission's order also granted Duquesne leave to increase its electric operating revenues by approximately $105,850,000.

In response to the Commission's order of January 28, 1983, the OCA petitioned for reconsideration and modification, asserting that the order violated the newly-enacted section 1315 of the Code. The Commission granted reconsideration, but proceeded to affirm its order after concluding that section 1315 did not prohibit its treatment of the costs in question. In the Commission's view, the statute was not intended to prevent "the recovery of prudent investment in a plant which is prematurely retired or one which is cancelled by reason of a change in economic circumstances." According to the Commission, section 1315 of the Code only barred adding the costs of incomplete construction to an electric utility's *rate base*, and did not disallow passing those costs on to ratepayers through *amortization*. Regarding the express dictate in section 1315 that such costs "shall not be made part of the rate base *nor otherwise included in the rates charged*" (emphasis added), the Commission opined that the foregoing statutory language was intended solely to prevent the regulatory agency from giving a utility dual benefits of the costs, *i.e.*, including the costs in the rate base *and* in some other rate making process. The Commission further concluded that the proscription in section 1315 was but a mirror of the agency's historic regulatory approach to the costs of construction work in progress.

On May 18, 1983, in response to the Commission's denial of the request for modification, the OCA petitioned the Commonwealth Court to review the Duquesne rate order. A petition for review was also filed, jointly, by the several commercial complainants. The sole issue raised in both appeals was the validity of the Commission's decision to allow Duquesne to recover, in its rates, its share of the costs of the cancelled plants.

In July of 1983 another CAPCO member, Pennsylvania Power Company ("Penn Power"), filed a tariff proposing to raise its annual electric revenues by $19,980,000. In connection with that request Penn Power sought to amortize over a span of ten years the sum of $9,569,665, which represented its share of the costs of the four terminated construction projects. As a further matter, Penn Power sought to add $824,074 to its rate base because of certain investments denominated "land held for future use." This latter item referred to interests in unimproved land held by the utility purportedly for future use as the sites electric substations and transmission wires. According to the utility's projections, the land would be devoted to such uses within the next ten years. Another request made by Penn Power was that it be allowed to normalize the income-tax consequences of a change in depreciation methodology. Each of the foregoing requests was opposed by the OCA.

By an order dated April 11, 1984, the Commission granted Penn Power a rate increase of $15,364,000. Relying on its decision in the Duquesne rate case, the regulatory agency accorded Penn Power the same ten-year amortization right.[4] As for the land investments,

[4]Penn Power received the same favorable treatment in the ALJ's investigation report that Duquesne had been given.

the utility was permitted to include their cost in its rate base. To justify that part of its decision, the Commission pointed to what was described as its traditional policy of allowing such investments to be included in a utility's rate base if the property is held pursuant to a definite plan for its use within a "reasonable time." The agency determined that the land interests in question, though conceivably to remain unused for up to ten years, met that requirement. In this regard, the Commission observed that "historically" land or facilities held by a utility for future use in the public service have been a subject "separate and distinct from that of construction work in progress." In the agency's perception, the legislature did not intend to abrogate that policy in enacting section 1315 of the Code. Penn Power also prevailed on its tax normalization claim.

The Commission's order in favor of Penn Power caused the OCA to file another petition for review with the Commonwealth Court. As in the Duquesne case the challenge was made that the order of the regulatory agency, in its treatment of certain costs incurred by the utility, violated section 1315 of the Code. The OCA also sought reversal of the ruling on the tax normalization issue.

For purposes of argument and disposition the Commonwealth Court consolidated the appeals in the Duquesne and Penn Power cases. Then, by a four to three decision, that court held that the Commission had correctly construed section 1315. *Cohen v. Pennsylvania Public Utility Commission*, 90 Pa.Cmwlth. 98, 494 A.2d 58 (1985). Opining that section 1315 is ambiguous, the Commonwealth Court majority looked first to the title of Act No. 335 as a construction aid. The title declares that the Act provides "a *limitation* on the consideration

of certain costs in the *rate base* for electric public utilities." (Emphasis added.) Of the preceding quoted phrase, the court said that it relates exclusively to the rate base "and not a legislative intent to exclude the costs of cancelled facilities from the revenue or expense factors of ratemaking." *Id.* at 105, 494 A.2d at 61.

The Commonwealth Court thus concluded that the legislature intended the prohibition in section 1315 to apply *only* to rate base considerations, and not at all to expense allowances. As further support of that conclusion the majority opinion cited other, pre-existent provisions of the Code, namely sections 1307 and 1310, 66 Pa.C.S. §§ 1307, 1310. Those two sections, according to the court's reading of their significance to ratemaking, evince a long-standing legislative intention to restrict only the elements of a utility's rate base, not the items that can be allowed as operating expenses. As for the part of section 1315 upon which the OCA relied, *i.e.*, the disjunctive phrase "*nor otherwise included in the rates charged*," the Commonwealth Court agreed with the Commission's view that the phrase was meant only to prevent a utility from gaining dual benefits from the challenged costs.

Having equipped itself with the reasoning described above, the Commonwealth Court affirmed the Commission's orders allowing Duquesne and Penn Power to amortize their respective shares of the costs of the cancelled nuclear plants. The court also affirmed the agency's decision to allow Penn Power to include in its rate base the cost of its investments in the unimproved land, concluding that the property was "used and useful" in the public service. However, the court reversed the Commission as to its grant of Penn Power's tax normalization request.[5]

[5]There was no cross-appeal taken from this part of the court's decision.

The OCA petitioned this Court for an allowance of appeal. Another such petition was filed by the commercial complainants who had joined as parties-appellant before the Commonwealth Court. We granted both petitions, in light of the public significance of the issues presented and implicated. After permitting Dequesne and Penn Power to intervene as appellees, we consolidated the cases for argument and decision.

Urging us to reverse the Commonwealth Court's decision relating to the cancelled plant costs and the land investments, the appellants repeat their arguments based on section 1315 of the Code. The Commission, unsurprisingly asserting that the court below correctly decided both questions, re-expounds the reasoning the agency pursued in making its final adjudications. Giving its reasoning a somewhat different emphasis, the Commission here argues that section 1315 was intended to prevent a utility from *earning a rate of return on such costs*, but not to disallow their *recovery* if the expenditures were prudently made. Contending that its reasoning reflects the legislative intent underlying section 1315, the agency directs our attention to section 520 of the Code, 66 Pa.C.S. § 520, a provision which became effective on October 10, 1985, almost three years after the enactment of section 1315. Section 520(c) provides as follows:

> (c) Regulatory treatment of *costs*.—Notwithstanding any other provisions of this title, *for a generating unit canceled after the effective date of this section*, either voluntarily or by commission order, *an electric utility may be permitted to recover a return of, but not a return on, prudently incurred costs on any partially completed facility when cancellation is found by the commission to be in the public interest*. The burden of proof to show that any costs claimed were prudently incurred shall be on the public utility.

(Emphasis added.) 66 Pa.C.S. § 520(c).

In the Commission's view, the 1985 provision for the recovery of cancelled plant costs indicates that the legislature had the same intent when it enacted section 1315 in December of 1982. The Commission further maintains that, with respect to the cancelled plant costs of Duquesne and Penn Power, its decision to permit recovery through amortization was a discharge of its duty to balance the interests of consumers and utility investors when determining what are "just and reasonable" rates.

The two intervenors, Duquesne and Penn Power, add arguments of a different dimension. The utilities argue that section 1315, if given the construction propounded by the appellants, would violate both the federal and state constitutions. They assert that if not allowed to recover from ratepayers prudently incurred costs of cancelled plant projects, such a ban will amount to a confiscation or "taking" of their property without just compensation. The intervenors also contend that, since section 1315 of the Code applies only to electric utilities, it violates the equal protection clause of the United States Constitution, and the prohibition against special legislation set forth in Article III, Section 32 of the Pennsylvania Constitution. The utilities advance two other constitutional arguments: that section 1315 denies them due process of law because the legislature made it retroactive; and that Act No. 335, which added section 1315 to the Code, violates the state constitution because the title of the Act does not suggest that the legislation encompasses anything other than rate base considerations.[6]

[6] By "title" the intervenors refer to the first five quoted lines of Act No. 335 following the words "An Act." Although the Commission calls that group of words a "preamble," we consider "title" to be the more accurate designation and will refer to it as such. *See generally* Sutherland, *Statutory Construction*, §§ 20:03, 20:10, and 22:08 (4th ed. 1985) (difference between preamble and title).

Statutory Interpretation

We will consider first the competing assertions concerning the proper interpretation of section 1315. As previously noted, the OCA and the other appellants rely on the section's express statement that construction costs "shall not be made part of the rate base nor otherwise included in the rates charged by the electric utility until such time as the facility is used and useful in service to the public." To the appellants the crucial element in that proscription, relative to the instant case, is the phrase *"nor otherwise included in the rates charged."* Because of that phrase, the appellants maintain that section 1315 is a clear statement of a legislative intent to bar electric utilities from recovering the costs of cancelled plants through rates charged to consumers. The Commission asserts that section 1315 suffers from an ambiguity: perceived by the agency as arising from the title of Act No. 335, which describes the legislation as "providing a limitation on the consideration of certain costs in the rate base of public utilities." To the Commission, it is significant that the preceding language mentions only *"the rate base,"* and does not include the more encompassing phrase *"nor otherwise included in the rates charged."* With that perception of an ambiguity the Commission argues that section 1315 requires interpretation; and further argues, along lines we have already mentioned, that the legislature's actual intent is reflected by the more limited terms of the title of Act No. 335.

It is well settled that the object of all interpretation and construction of statutes is to ascertain and effectuate the intention of the legislature as expressed by the words employed. 1 Pa.C.S. § 1921(a); *Commonwealth v. Fisher*, 485 Pa. 8, 400 A.2d 1284 (1979); *Pennsylvania Human Relations Commission v. Alto-Reste Park Cemetery*

Ass'n., 453 Pa. 124, 306 A.2d 881 (1973); *Clearview Bowling Center, Inc. v. Hanover Borough*, 430 Pa. 579, 244 A.2d 20 (1968).

It is fundamental that in ascertaining the legislature's intent, the plain words of its laws may not be ignored. *Stegmaier Estate*, 424 Pa. 4, 225 A.2d 566 (1967). A court may not alter, under the guise of interpretation, the express language and intent of the legislature. *Commonwealth v. Pope*, 455 Pa. 384, 317 A.2d 887 (1974); *see Zimmerman v. O'Bannon*, 497 Pa. 551, 442 A.2d 674 (1982). Thus, where the words of a statute are clear and free from ambiguity, a court may go no further to determine the legislative intent. *Kritz Estate*, 387 Pa. 223, 127 A.2d 720 (1956); *Rich v. Meadville Park Theatre Corp.*, 360 Pa. 338, 62 A.2d 1 (1948); *Commonwealth ex rel. Smith v. Clark*, 331 Pa. 405, 200 A. 41 (1938); *see* 1 Pa.C.S. § 1921(b), (c). It is only when the words of the statute are not explicit that the intention of the legislature may be ascertained by considering other means of statutory interpretation or construction. *Davis v. Sulcowe*, 416 Pa. 138, 205 A.2d 89 (1964); *Commonwealth v. Chester County Light and Power Co.*, 339 Pa. 97, 14 A.2d 314 (1940).

Language is "ambiguous" when it conveys two or more reasonable meanings; or when it is otherwise vague, uncertain or indefinite. See WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY. Of the two statutory phrases respectively championed by the opposing parties, as expressing the legislative intent underlying section 1315, neither of those two wordsets is of itself facially ambiguous. On its face, there is nothing vague or uncertain about the language of the title. The phrase "limitation on the consideration of certain costs in the rate base" clearly describes a specific subject of concern: the impact of certain costs on an

electric utility's *rate base*. If this phrase is read as the controlling expression of legislative intent, it could only mean that the legislature's sole purpose in enacting section 1315 was to exclude the costs of uncompleted construction projects from the utility's rate base. It would then follow that the statute itself was not intended to bar a utility from charging those costs to ratepayers as operating expenses. On the other hand, there is nothing facially vague, uncertain or indefinite about the substantive proscription in section 1315 itself. That proscription clearly conveys but one meaning: that the cost of uncompleted projects shall not only be excluded from the rate base, but shall not, in any way whatsoever, be included in the rates charged.

Thus, the interpretational problem that confronts us here is one arising from an inconsistency of legislative articulation in the same enactment. To solve that problem we need look no further than the rule of statutory interpretation set forth in section 1934 of the Statutory Construction Act of 1972, 1 Pa.C.S. § 1934. This rule mandates that: "[e]xcept as provided in section 1933 of this title (relating to particular controls general), *whenever, in the same statute, several clauses are irreconcilable, the clause last in order of date or position shall prevail.*" (Emphasis added.) Since, in our view, the disjunctive proscription in section 1315 is of itself unambiguous, and since it is positioned after the title of the statute by which it was enacted, the terms of that proscription must prevail over the language of the title as being the expression of legislative intention. Moreover, it is an established principle of our jurisprudence that, where the enacting clause of a statute is clear and unambiguous, the title will not be permitted to contradict it. *Commonwealth v. Magwood*, 503 Pa. 169, 469 A.2d

115 (1983); *American Surety Company's Case*, 319 Pa. 549, 181 A. 364 (1935); *Commonwealth ex rel. The Alliance Petroleum and Coal Co. v. Slifer*, 53 Pa. 71 (1866). The same is true with respect to preambles. *American Surety Company's Case*. Although titles and preambles are accepted aids in resolving ambiguity in an enacting clause, they may not be used to create ambiguity where none exists in the clause.

We therefore hold that section 1315 of the Code must be read as prohibiting an electric utility from recovering the costs of cancelled plants from ratepayers, either by making such costs part of its rate base or by converting them into operating expenses through amortization. For us to reach any other conclusion, we would have to treat as surplusage that part of section 1315's proscription which says: "*. . . nor otherwise included in the rates charged by the electric utility.*" It is well settled that the legislature cannot be deemed to intend that its language be superfluous and without import. *E.g., Colodonato v. Consolidated Rail Corp.*, 504 Pa. 80, 470 A.2d 475 (1983); *Consumers Education and Protective Ass'n. v. Nolan*, 470 Pa. 372, 368 A.2d 675 (1977); *Daly v. Hemphill*, 411 Pa. 263, 191 A.2d 835 (1963); *Commonwealth v. Mack Bros. Motor Car Co.*, 359 Pa. 636, 59 A.2d 923 (1948).

The appellate courts of several other jurisdictions have interpreted their state law as preventing an electric utility from treating as "operating expenses," and thus recovering from ratepayers, the costs of cancelled nuclear projects. One such case is *Office of Consumers' Counsel v. Public Utilities Commission of Ohio*, 67 Ohio St.2d 153, 423 N.E.2d 820 (1981), *appeal dismissed sub nom. Cleveland Electric Illuminating Co. v. Office of Consumers' Counsel*, 455 U.S. 914, 102 S.Ct. 1267, 71 L.Ed.2d

455 (1982). In that case, the state regulatory body granted an electric utility a rate increase of approximately $70,000,000, and, in conjunction, allowed the utility to amortize over a ten-year period its $56,000,000 investment in four cancelled nuclear power plants. The Supreme Court of Ohio reversed the agency's order as to the amortization, holding that to allow the utility to amortize its investment in the terminated projects, and thus permit its recovery from ratepayers as operating expenses, violated state law. The court concluded that under Ohio's rate statute a utility's recoverable costs were limited to those which are ordinary and recurrent in the rendition of service to the public, and that the sunk costs of uncompleted capital projects did not come within that category. In the words of the opinion supporting the court's decision, "what the company sought and what the Commission granted was the amortization *as service-related costs* of an investment that never provided any service whatsoever to the utility's customers." 67 Ohio St.2d at 164, 423 N.E.2d at 827 (emphasis added). The opinion further stated that, in the absence of explicit statutory authorization, the regulatory agency could not benefit a utility's investors by guaranteeing the full return of lost capital at the expense of the ratepayers. *Id.* at 167, 423 N.E.2d at 829. It is worth noting that the utility in the foregoing case, Cleveland Electric Illuminating Company, was a member of CAPCO, and that the four cancelled projects there in issue are the same ones which are involved in the appeals now before us.

The Supreme Court of Wyoming, in *Pacific Power & Light Co. v. Public Service Commission of Wyoming*, 677 P.2d 799 (Wyo.1984), rejected an electric utility's attempt to compel its customers to bear the cost, through

rates, of its expenditures and obligations in connection with cancelled nuclear power construction projects. The electric company, while recognizing that the terminated projects did not constitute "used and useful" property within the meaning of Wyoming's utility statute, nevertheless asserted that the implicated costs were includible in its rate base as prudently incurred operating expenses. The Supreme Court of Wyoming rejected that argument for several reasons, not the least of which was its conclusion that such capital costs did not qualify as "operating expenses," prudent or otherwise. A comparable result was reached by the Court of Appeals of Indiana in the case of *Citizens Action Coalition v. Northern Indiana Public Service Co.*, 472 N.E.2d 938 (Ind.Ct.App. 1984). That court expressly embraced the decisions in *Office of Consumers' Counsel, supra*, and *Pacific Power & Light Co., supra*, as being consonant with Indiana law.

Also deserving of mention is the 1984 decision of the Supreme Court of New Hampshire in *Appeal of Public Service Co. of New Hampshire*, 125 N.H. 46, 480 A.2d 20 (1984). That case, too, involved an attempt by an electric utility to recover from its ratepayers the cost of its financial participation in a subsequently aborted project to build a nuclear generating plant. The utility had become part owner of the project in 1972; and, by 1981, when the project was cancelled, the company's investment in the uncompleted construction was nearly $16,000,000. The New Hampshire court held that, by force of a statute enacted in 1979, such costs could neither be included in the utility's rate base nor amortized as an operating expense. The statutory provision relied on by the court stated that: "At no time shall any rates or charges be based upon any costs associated with construction work if said construction work is not

completed." RSA 378: 30-a (Supp.1981). The same statute continued with the following mandate:

> All costs of construction work in progress, including, but not limited to, any costs associated with constructing, owning, maintaining, or financing construction work in progress, shall not be included in a utility's rate base *nor be allowed as an expense for rate making purposes* until, *and not before*, said construction project is *actually providing service to consumers*. (Emphasis added.)

In our view, the substantive terms of the New Hampshire statute bear a striking resemblance to section 1315 of our Public Utility Code.[7]

The Commission's reference to section 520(c) of the Code is unavailing. It is true that, as a result of the enactment of section 520, electric utilities are *now* permitted to recover cancelled plant costs under certain circumstances and conditions. However, as we have already pointed out, section 520 was enacted in 1985—almost three years after section 1315 was added to the Code. The perceptions and purposes of the legislature in 1985 did not necessarily mirror those which existed in 1982, when section 1315 became law. We have not been presented with any persuasive reason for concluding that they were the same. We are concerned with the legislative intent underlying the 1982 statute, section 1315; for that is the one which applies to the instant matters. We are not here concerned with the legis-

[7]Other appellate courts have held that an electric utility does have the right to amortize the costs of cancelled nuclear projects. *E.g.*, *Attorney General v. Department of Public Utilities*, 390 Mass. 208, 455 N.E.2d 414 (1983); *People's Organization for Washington Energy Resources v. Washington Utilities and Transportation Commission*, 104 Wash.2d 798, 711 P.2d 319 (1985). Such decisions, however, rested on conclusions about the governing statute, *i.e.*, that it did not deprive the regulatory body of authority to allow amortization.

lature's intent, during a later session, in enacting a statute which does not apply to the case before us. Furthermore, any attempt to impute relevance to section 520 cannot ignore the fact that it was made to operate *prospectively only*. Such is an indication that the legislature, in belatedly conferring upon electric utilities a conditional right to recover cancelled plant costs, did not intend for the utilities to have that right prior to the effective date of the 1985 statute.

We turn next to the question of whether the Commission was correct in deciding that Penn Power's rate base could be increased by the amount of its investments in the vacant land. As mentioned, the Commission based its decision on a finding that Penn Power had a definite plan earmarking the unimproved land for use, "within a reasonable time," as sites of transmission lines and substations. The OCA, in disputing the validity of the above ruling, starts with a premise that property owned by a utility may not be included in its rate base unless it is used and useful in the public service. In connection with that proposition, the OCA then focusses on the last sentence of section 1315, which in part here pertinent, states: "[n]o electric utility property shall be deemed *used and useful* until it is *presently providing actual utility service to the customers*." (Emphasis added.) In the view of the OCA, Penn Power's planned, future use of the vacant land did not render it "used and useful" under the standard dictated by the above statutory language. This contention was, as noted, rejected by the court below.

The threshold premise of the OCA's argument concerning the vacant land is legally accurate. One of the cardinal principles of this state's public utility law is that, in the setting of rates for services to the public, a

utility company is entitled to a return only on such of its property as is "used and useful" in the public service. *E.g., Pennsylvania Electric Co. v. Pennsylvania Public Utility Commission*, 509 Pa. 324, 502 A.2d 130 (1985); *Scranton v. Scranton Steam Heat Co.*, 405 Pa. 397, 176 A.2d 86 (1961); *Erie City v. Public Service Commission*, 278 Pa. 512, 529, 123 A. 471, 478 (1924); *City of Pittsburgh v. Pennsylvania Public Utility Commission*, 171 Pa.Super. 187, 90 A.2d 607 (1952); *Newport Home Water Co. v. Public Service Commission*, 76 Pa.Super. 386 (1921); *UGI Corp. v. Pennsylvania Public Utility Commission*, 49 Pa.Cmwlth. 69, 410 A.2d 923 (1980); *see* 66 Pa.C.S. § 1310(d). The fact that a utility owns a property does not of itself justify its inclusion in the rate base; and the burden is on the utility to show that the property is "used and useful" in the public service. *City of Pittsburgh, supra.*

Based on the standard set forth by the final sentence of section 1315 of the Code, as to when the property of an electric utility may be deemed "*used and useful,*" we must conclude that the vacant land here in issue does not meet that test. Utility real estate that is vacant and, according to the utility's own plans, might remain so for as long as ten years, cannot reasonably be characterized as property "*presently providing actual utility service to the customers.*"[8] We thus hold that the addition of the land investments to Penn Power's rate base violated the terms of section 1315 of the Code.[9]

[8]Penn Power's reliance on our decision in *Barasch v. Pennsylvania Public Utility Commission*, 507 Pa. 430, 490 A.2d 806 (1985) is misplaced. In that case we held that a utility could properly include in its rate base the cost of nuclear fuel purchased for use in an uncompleted nuclear plant. However, an important fact in the case was that the fuel could also have been used in other facilities that were currently in service. Utilities have traditionally been allowed to recover the cost of usable supplies and materials.

[9]*See Boston Edison Co. v. Dep't. of Public Utilities*, 375 Mass. 1, 375 N.E.2d 305 (1978) (pointing out that utility was free to sell land at a profit, which would benefit stockholders, not ratepayers).

Constitutional Challenges

According to the intervenors, a statute which disallows inclusion of the cancelled plant costs in the rate base, and also bars as an alternative their being treated as operating expenses, works a confiscation of utility property without just compensation, in violation of the federal and state constitutions.

It is of course true that the property of a public utility, though devoted to the public service and convenience, is still private property; and neither the corpus of that property nor the use thereof can be constitutionally taken for a compulsory price which falls below the measure of just compensation. *E.g., United Railways and Electric Co. of Baltimore v. West*, 280 U.S. 234, 50 S.Ct. 123, 74 L.Ed. 390 (1930). This deeply-rooted principle of constitutional law had been articulated in more abbreviated form in the landmark case of *Smyth v. Ames*, 169 U.S. 466, 18 S.Ct. 418, 42 L.Ed. 819 (1898), in which the Supreme Court of the United States declared that a public utility "may not be required to use its property for the benefit of the public without receiving just compensation for the services rendered by it." *Id.* at 546, 18 S.Ct. at 433. An even earlier formulation of the same precept is to be found in *Railroad Commission Cases*, 116 U.S. 307, 6 S.Ct. 1191, 29 L.Ed. 636 (1886).

The "just compensation" safeguarded to a utility by the fourteenth amendment of the federal constitution is a reasonable return on the fair value of its property at the time it is being used for public service. *Denver Union Stock Yard Co. v. United States*, 304 U.S. 470, 58 S.Ct. 990, 82 L.Ed. 1469 (1938); *Los Angeles Gas Co. v. Railroad Commission*, 289 U.S. 287, 53 S.Ct. 637, 77 L.Ed. 1180 (1933); *McCardle v. Indianapolis Water Co.*, 272 U.S.

400, 47 S.Ct. 144, 71 L.Ed. 316 (1926); *Board of Commissioners v. New York Bell Telephone Co.*, 271 U.S. 23, 46 S.Ct. 363, 70 L.Ed. 808 (1926); *Willcox v. Consolidated Gas Co.*, 212 U.S. 19, 29 S.Ct. 192, 53 L.Ed. 382 (1909); *Pennsylvania Electric Co. v. Pennsylvania Public Utilities Commission, supra.* Thus, the *return* which a utility is constitutionally entitled to earn relates only to its property that is employed in the public service. *Bluefield Water Works Co. v. Public Service Commission*, 262 U.S. 679, 43 S.Ct. 675, 67 L.Ed. 1176 (1923); *Smyth v. Ames, supra; Railroad Commission Cases, supra.* In that regard, the Supreme Court has held that it is only when a utility's property is *"used and useful"* in the public service does the federal constitution require its inclusion in the rate base, upon which the return is calculated. *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575, 62 S.Ct. 736, 86 L.Ed. 1037 (1942); *Denver Union Stock Yard Co. v. United States, supra.* A refined version of the same principle can be found in *Columbus Gas & Fuel Co. v. Public Utilities Commission*, 292 U.S. 398, 54 S.Ct. 763, 78 L.Ed. 1327 (1934). There, the Supreme Court held that a utility's rate base need not include assets not presently in use, *"unless the time for using them is so near that they may be said, at least by analogy, to have the quality of working capital."* *Id.* at 406.

In addressing the confiscation argument, we must recognize that a public utility's constitutional right to "just compensation" encompasses not only rate base considerations, but also includes the utility's right to recover from ratepayers the expenses and costs of operation. *West Ohio Gas Co. v. Public Utilities Commission*, 294 U.S. 63, 55 S.Ct. 316, 79 L.Ed. 761 (1935); *United Railways and Electric Co. of Baltimore v. West, supra; Smyth v. Ames, supra; Covington & Lexington Turnpike*

Road Co. v. Sandford, 164 U.S. 578, 17 S.Ct. 198, 41 L.Ed. 560 (1896). Indeed, a utility's earned return on its rate base is to be measured only after its operating expenses have been deducted from gross revenues; and prescribed rates which are not sufficient to allow recovery of operating expenses, in addition to providing a fair return on the rate base, are confiscatory. *E.g., United Railways and Electric Co. of Baltimore v. West, supra.* However, just as a utility has no constitutional right to have included in its rate base assets which are not "used and useful" in the public service, so too may it be restricted as to what items it can properly claim as operating expenses.

In *Lindheimer v. Illinois Bell Telephone Co.*, 292 U.S. 151, 54 S.Ct. 658, 78 L.Ed. 1182 (1934), the Supreme Court described the "operating expenses" of a public utility as *"the cost of producing the service."* *Id.* at 167, 54 S.Ct. at 665 (emphasis added). The Court, observing that "[c]harges to operating expenses may be as important as valuations of property," pointed out that an improper inflation of operating expenses would produce the same result as an increase of the allowed rate of return on the rate base. *Id.* at 164, 54 S.Ct. at 663. The Court, in *Lindheimer*, went on to hold that the ratemaking authority could properly exclude from a utility's claimed operating expense the amount of excessive depreciation charges. The depreciation charges there involved were deemed excessive because they went far beyond any realistic measure of the degree to which the utility's plant was being consumed by use in the public service. In the case of *Dayton Power & Light Co. v. Public Utilities Commission*, 292 U.S. 290, 54 S.Ct. 647, 78 L.Ed. 1267 (1934), the Supreme Court held that a state, in fixing rates for a utility, may exclude from reported operating expenses unreasonable amounts which the

utility paid to an affiliated company for supplies. *See also Columbus Gas & Fuel Co. v. Public Utilities Commission, supra.* It is thus clear that the federal constitution does not confer upon a public utility the right to claim, for ratemaking purposes, whatever it sees fit to include in the category of "operating expenses." In that regard, the significance of the *Lindheimer* and *Dayton Power & Light Co.* cases may be stated thus: principles of "just compensation" under the federal constitution do not endow a public utility with the right to burden ratepayers with what the utility calls an "operating expense" unless such item, in addition to being reasonable in amount, represents a cost of providing *present* utility service.

We have not been presented with any convincing argument for concluding that the "just compensation" provision of our state constitution compels a broader conception of the nature of an "operating expense." The judicial decisions of this state are not wanting in expressions concerning the type of outlays or cost items which a utility may properly charge to ratepayers as operating expenses. For example, in *Shirk v. Lancaster City,* 313 Pa. 158, 169 A. 557 (1933), this Court generally defined a utility's "operating cost" as including "all charges and expenses involved in the *production, supply and distribution of the commodity.*" *Id.* at 171, 169 A. at 563 (emphasis added).[10] Later, in *Barasch v. Pennsylvania Public Utility Commission,* 507 Pa. 561, 493 A.2d 653 (1985), we indicated that "proper operating expenses" are ones which relate to the *cost of service.* We have also observed, regarding a utility's right to recover expenses, that the

[10]As examples of such expenses, the Court included such items as salaries, telephone, insurance, taxes and stationery.

policy in this state has been for current ratepayers to bear "only the actual expenses of *providing current utility service*" and that such policy was reaffirmed in the enactment of section 1315 of the Public Utility Code. *Barasch v. Pennsylvania Public Utility Commission,* 507 Pa. 496, 516-17, 491 A.2d 94, 104 (1985) (emphasis added); *see also Pennsylvania Electric Co. v. Pennsylvania Public Utility Commission, supra.* These expressions basically coincide with the mentioned federal view of what kinds of costs a utility is constitutionally entitled to pass to ratepayers under the classification of "operating expenses." Therefore, without the benefit of a valid and otherwise applicable statute conferring a broader right, the only expenses which a public utility in this state may recover from ratepayers, through rates, are those expenses which represent the actual cost of providing *present* utility service. That is so regardless of whatever convenient accounting label the utility might employ to characterize a nonqualifying outlay.

It is absolutely clear that the four uncompleted nuclear plants here involved have no capacity to produce any present utility service to the customers of the two intervenors. Those aborted projects are of no use whatsoever to the public. It should be recalled that in *Pennsylvania Electric Co. v. Pennsylvania Public Utility Commission, supra,* we held that a nuclear reactor at Three Mile Island was properly excluded from the utility's rate base because it had been so damaged by a near melt-down as to be useless in the public service. Certainly, no reasonable argument can be made that the four uncompleted plants have any higher degree of usefulness. Given that the terminated plants are so useless as to preclude their being an element of a utility's rate base, we cannot imagine by what magic the inter-

venors' investments in the useless projects can be considered a cost of providing present utility service as to qualify as "operating expenses." We therefore hold that interpreting section 1315 of the Code as barring the amortization of cancelled plant costs does not work an unconstitutional confiscation of utility property.

As a further constitutional challenge, intervenor Duquesne argues that section 1315 is violative of due process standards because it was made to operate retroactively. We reject this argument as being without merit. Neither the federal constitution nor our state constitution invalidates a non-penal statute merely because it is retroactive, unless such legislation impairs contractual or other vested rights. *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 96 S.Ct. 2882, 49 L.Ed.2d 752 (1976); *Chase Securities Corp. v. Donaldson*, 325 U.S. 304, 65 S.Ct. 1137, 89 L.Ed. 1628 (1945); *Kentucky Union Co. v. Kentucky*, 219 U.S. 140, 31 S.Ct. 171, 55 L.Ed. 137 (1911); *League v. Texas*, 184 U.S. 156, 22 S.Ct. 475, 46 L.Ed. 478 (1902); *Campbell v. Holt*, 115 U.S. 620, 6 S.Ct. 209, 29 L.Ed. 483 (1885); *Krenzelak v. Krenzelak*, 503 Pa. 373, 469 A.2d 987 (1983); *Smith v. Fenner*, 399 Pa. 633, 161 A.2d 150 (1960). It cannot be said that either Duquesne or Penn Power had a contractual or other vested right to recover from ratepayers the cost of investments which do not provide utility service.

Duquesne also contends that because the title of Act No. 335 does not mention the retroactivity of section 1315 the legislation is invalid. As support for that assertion, the company relies on Article III, section 3 of the Pennsylvania Constitution, which in part states: "No bill shall be passed containing more than one subject, which shall be clearly expressed in its title. . . . " This argument must fail. The preceding constitutional provi-

sion requires merely that the title of a statute put reasonably inquiring minds on notice of the legislation's contents. *In re Condemnation by Commonwealth, Department of Transportation*, 511 Pa. 620, 515 A.2d 899 (1986); *L.J.W. Realty Corp. v. City of Philadelphia*, 390 Pa. 197, 134 A.2d 878 (1957); *In re Gumpert's Estate*, 343 Pa. 405, 23 A.2d 479 (1942). All that is required is that the title shall contain words sufficient to cause one having a reasonably inquiring state of mind to examine the statute to determine whether he may be affected by it. *Boyertown Burial Casket Co. v. Commonwealth*, 366 Pa. 574, 79 A.2d 449 (1951). Although Act No. 335 does not in its title mention the retroactivity of section 1315, such is expressly set forth in the next-to-last part of the Act. We cannot believe that a statute's title which announces that the legislation is an amendment of the Public Utility Code, and which also mentions "*providing a limitation on the consideration of certain costs in the rate base for electric public utilities*," would not induce an electric-utility company to examine and study the entire enactment.

Duquesne and Penn Power join in making the additional assertions that Act No. 335 denies them the equal protection of the laws as guaranteed by the Fourteenth Amendment of the United States Constitution, and that the Act also violates the prohibition against "special legislation" set forth in Article III, section 32 of the Pennsylvania Constitution. These arguments are predicated on the fact that Act No. 335, by its terms, applies only to electric-utility companies, and not to other type public service companies such as gas and water utilities. The intervenors contend that, if the public interest is served by protecting utility ratepayers from being burdened with the costs of unproductive construction

projects, a statute which targets only electric utilities in that regard is an unreasonable, and thus unconstitutional, classification.

The equal protection clause of the United States Constitution requires that " 'all persons similarly circumstanced shall be treated alike.' " *Plyler v. Doe*, 457 U.S. 202, 102 S.Ct. 2382, 72 L.Ed.2d 786 (1982); *F.S. Royster Guano Co. v. Virginia*, 253 U.S. 412, 415, 40 S.Ct. 560, 562, 64 L.Ed. 989 (1920). Among its various applications, the equal protection clause of the federal constitution forbids a state legislature from imposing on a person, natural or artificial, or on a class, burdens which are not cast upon others similarly situated. *E.g., Atchison, Topeka and Santa Fe R.R. v. Matthews*, 174 U.S. 96, 19 S.Ct. 609, 43 L.Ed. 909 (1899). The equal protection of the laws, it has been said, means that the rights of all persons must rest upon the same *rule* under similar circumstances. *Hartford Steam Boiler Inspection and Insurance Co. v. Harrison*, 301 U.S. 459, 461, 57 S.Ct. 838, 839, 81 L.Ed. 1223 (1937); *Louisville Gas & Electric Co. v. Coleman*, 277 U.S. 32, 37, 48 S.Ct. 423, 425, 72 L.Ed. 770 (1928).

The intervenors in the case at bar, in asserting that Act No. 335 denies them the equal protection of the laws, assume that, because the legislation applies exclusively to electric utilities, it will have the effect of requiring only public utilities of that class to bear the burden of aborted construction projects but will permit other type utilities to pass such costs on to their ratepayers. This assumption is palpably erroneous. Given what we have already said about the fundamental principles of this state's public-utility jurisprudence, it should be clear that no utility of any type is permitted, without express and valid legislative authorization, to

charge ratepayers for property which is not used and useful in the production of current utility service. In our view, Act No. 335 was mainly an attempt by the 1982 legislature to make clear, by codification, that the above mentioned general principle of utility law should govern the then-ongoing efforts of some electric utilities to recover cancelled plant costs from their customers.

There is nothing in Act No. 335 to indicate that the legislature which enacted it, after going to such lengths to make it absolutely clear that the Commission had no authority to allow the electric utilities to recover the costs of uncompleted projects, also intended to abrogate pre-existent legal principles which would compel the same result with respect to other type public utilities. Indeed, the very last sentence in section 2 of the Act expressly states: "Nothing contained in this act shall be construed to modify or change *existing law* with regard to the rate making treatment of investment in facilities of *fixed utilities other than electric utilities*." (Emphasis added.) We read this proviso to mean that, although the Act focusses on electric utilities, such does not mean that other type utilities are relieved of the proscriptions of pre-existing law concerning the recovery of costs. Thus, Act No. 335 has no disparate impact on electric utilities; and, for that reason, we conclude that the statute does not deny the intervenors the equal protection of the laws. *See Califano v. Boles*, 443 U.S. 282, 99 S.Ct. 2767, 61 L.Ed.2d 541 (1979); *National Union of Marine Cooks & Stewards v. Arnold*, 348 U.S. 37, 75 S.Ct. 92, 99 L.Ed. 46 (1954). In determining whether the equal protection guaranteed by the federal constitution has been afforded, consideration must be given to the entire body of law operating upon the subject matter in issue. *See Interstate Busses Corp. v. Blodgett*, 276 U.S. 245, 48 S.Ct.

230, 72 L.Ed. 551 (1928); *Farmers and Mechanics Savings Bank v. Minnesota*, 232 U.S. 516, 34 S.Ct. 354, 58 L.Ed. 706 (1914); *see also Louisville Gas & Electric Co. v. Coleman*, *supra*, at 50 (Brandeis, J., dissenting).

Regarding the bar against "special legislation" contained in Article III, section 32 of the Pennsylvania Constitution, this Court has held that the provision, in its meaning and purpose, is sufficiently similar to the equal protection clause of the United States Constitution as to warrant like application. *Laudenberger v. Port Authority of Allegheny County*, 496 Pa. 52, 67 n. 13, 436 A.2d 147, 155 n. 13 (1981); *Baltimore & Ohio R.R. v. Commonwealth, Department of Labor & Industry*, 461 Pa. 68, 334 A.2d 636 (1975). Therefore, the same considerations that invalidate the intervenors' reliance on the federal guarantee also defeat their resort to the analogous provision in our state constitution.

We hold that the Public Utility Commission exceeded its lawful authority in allowing Duquesne and Penn Power to amortize the costs of the cancelled construction projects. We also conclude that the Commission erred likewise in permitting Penn Power to add to its rate base the cost of its investments in the vacant land here involved. It is clear, beyond any need for citation, that the function of ratemaking for public utilities is legislative in nature. The Commission is but an instrumentality of the state legislature for the performance of that function; and the agency has only such powers as are expressly conferred upon it by statute or exist by necessary implication. *E.g., City of Philadelphia v. Philadelphia Electric Co.*, 504 Pa. 312, 473 A.2d 997 (1984). By entering the decisions here reviewed, the Commission not only failed to apply long-established principles

of public utility law, but also failed to heed the legislature's statutory re-confirmation of them with respect to the costs at issue in these cases.

For the reasons set forth herein, the orders of the Commonwealth Court are reversed. These causes are hereby remanded to the Commission for proceedings consistent with this opinion.

APPENDIX B

Opinion of the Pennsylvania Commonwealth Court

Walter W. COHEN, Consumer Advocate, Petitioner,

v.

PENNSYLVANIA PUBLIC UTILITY COMMISSION, Respondent.

David M. BARASCH, Consumer Advocate, Petitioner,

v.

PENNSYLVANIA PUBLIC UTILITY COMMISSION, Respondent.

Commonwealth Court of Pennsylvania.
Argued April 10, 1985.
Decided June 13, 1985.
As Amended June 14, 1985.

BARRY, Judge.

553 C.D. 1983

The Office of Consumer Advocate (OCA) appeals a final order of the Pennsylvania Public Utility Commission (PUC) which permitted inclusion in its rate base of the cost of construction of four cancelled nuclear plants by Duquesne Light Company (Duquesne).

In 1967, Duquesne became a member of the Central Area Power Coordination Group (CAPCO)[1] which developed a plan to construct seven nuclear power plants. In January, 1980, CAPCO, however, cancelled plans to construct four nuclear plants. At that time Duquesne's share of the expended cost was $34,697,389.00. In April, 1982, Duquesne requested an

[1]The other members of CAPCO are Pennsylvania Power Company (Penn Power), Cleveland Electric Illuminating Company, Ohio Edison and Toledo Edison.

annual base rate increase of $155,000,000.00 effective June 29, 1982.

In January, 1983, the PUC issued a final order which granted Duquesne $105,850,000.00 on its rate request and allowed an annual revenue of $3,469,739.00 representing the amortization for the first year of a ten year period of the costs of $34,697,389.00 for the four cancelled nuclear plants. Thereafter, the OCA filed for reconsideration and modification based on a newly enacted statute added Section 1315 of the Public Utility Code (Code), 66 Pa.C.S. § 1315,[2] which allegedly disallowed recovery of these plant cancellation costs in rates.

The PUC denied this petition reasoning that Section 1315 was inapplicable to such costs. It held that Section 1315 prohibits the inclusion of the costs of plants not used and useful to the public in rate bases but does not prohibit the inclusion of reasonable costs of these plants in revenues as an expense.

The seminal issue involves whether costs of cancelled nuclear power plants can be included in Duquesne's rates. The resolution of this question depends upon whether Section 1315 prohibits amortization of the cancellation costs. Act 335, adding Section 1315, states as follows:

AN ACT

Amending Title 66 (Public Utilities) of the Pennsylvania Consolidated Statutes, providing a limitation on the consideration of certain costs in the rate base for electric public utilities.

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[2]Act of Assembly No. 335, approved December 30, 1982.

The General Assembly of the Commonwealth of Pennsylvania hereby enacts as follows:

Section 1. Title 66, act of November 25, 1970 (P.L. 707, No. 230), known as the Pennsylvania Consolidated Statutes, is amended by adding a section to read: § 1315. Limitation on consideration of certain costs for electric utilities.

Except for such nonrevenue producing, nonexpense reducing investments as may be reasonably shown to be necessary to improve environmental conditions at existing facilities or improve safety at existing facilities or as may be required to convert facilities to the utilization of coal, the cost of construction or expansion of a facility undertaken by a public utility producing, generating, transmitting, distributing or furnishing electricity shall not be made a part of the rate base nor otherwise included in the rates charged by the electric utility until such time as the facility is used and useful in service to the public. Except as stated in this section, no electric utility property shall be deemed used and useful until it is presently providing actual utility service to the customers.

Section 2. This act shall be applicable to all proceedings pending before the Public Utility Commission and the courts at this time. Nothing contained in this act shall be construed to modify or change existing law with regard to rate making treatment of investment in facilities of fixed utilities other than electric utilities.

Section 3. This act shall take effect immediately.

Our scope of review is limited to a determination of whether constitutional rights have been violated, an error of law committed or whether the findings, determinations or order of the PUC are supported by substantial evidence. *U.S. Steel Corp. v. Pennsylvania Public Utility Commission*, 37 Pa. Commonwealth Ct. 195, 390

A.2d 849 (1978). The interpretation given a statute by the agency charged with its execution and application is entitled to great weight and should be disregarded or overturned only for cogent reasons or if such construction is clearly erroneous. *Chappell v. Pennsylvania Public Utility Commission*, 57 Pa. Commonwealth Ct. 17, 425 A.2d 873 (1981).

The OCA contends that the PUC erred when it construed Section 1315 to allow amortization of the cancellation costs. It asserts that, under this provision, the cost of construction of an electric generating facility cannot be included in the rates charged until it is, by its definition, used and useful, that is, providing actual utility service. It thus maintains that Duquesne cannot amortize cancellation costs since the four plants will never provide service.

By contrast, it is the position of the PUC that, under Section 1315, Duquesne should be permitted to amortize its share of the cancelled plant costs over a ten year period because this provision does not prohibit the amortization of prudently incurred cancelled plant costs in customer rates. The PUC alleges it allowed Duquesne a recovery of its investment in the cancelled plants but that Duquesne received no return on its investment nor any portion of the cancelled plant costs. Section 1315, it asserts, merely codified the long standing practice of disallowing the inclusion of construction work in progress (CWIP) in the rate base.

In *Bell Telephone Co. v. Pennsylvania Public Utility Commission*, 47 Pa. Commonwealth Ct. 614, 408 A.2d 917 (1979), we stated that the Code

> authorizes utilities to seek a just and reasonable return on the fair value of property used and useful

> in the public service. What constitutes used and useful utility property is committed to the *discretion* of the Commission. If the Commission reasonably finds that a particular class of property is not used or useful in serving the public, it may exclude the value of that property from the *rate base* and thus disallow the utility's return on that property. (Emphasis added.)

47 Pa. Commonwealth Ct. at 629, 408 A.2d at 924. Furthermore, "[i]n the area of adjustments to rate base, the [PUC] has wide discretion." *UGI Corp. v. Pennsylvania Public Utility Commission*, 49 Pa. Commonwealth Ct. 69, 79, 410 A.2d 923, 929 (1980). In our view, the PUC has correctly applied Section 1315 and, therefore, we agree with its interpretation and analysis of this provision.

According to the rules of statutory construction, the title and preamble of a statute may be considered in the construction of that statute. Section 1924 of the Statutory Construction Act, 1 Pa.C.S. § 1924. The limiting title and preamble of Act 335, adding Section 1315, described itself as one "providing a limitation on the consideration of costs in the *rate base* for *electric* public utilities." (Emphasis added.) This phrase relates exclusively to a consideration of *rate base* and not a legislative intent to exclude the costs of cancelled facilities from the revenue or expense factors of ratemaking. This interpretation, moreover, may be inferred from the provisions of the Code where "used and useful" relates *only* to rate base inclusions and not at all to expense allowances. For instance, Section 1307 of the Code, 66 Pa.C.S. § 1307, provides that a public utility should establish rates which provide a just and reasonable return on the fair value of its property "used and useful" in

the public service; and, Section 1310 of the Code, 66 Pa.C.S. § 1310, authorizes the PUC to investigate rates which produce a possible return "in excess of a fair return . . . upon property used and useful in its public service." The Code nowhere employs this phrase regarding the allowance of items of expense. Case law also indicates that the "used and useful" concept is uniformly employed in considering only rate base questions. *See, for example, Philadelphia Electric Co. v. Pennsylvania Public Utility Commission*, 61 Pa. Commonwealth Ct. 325, 433 A.2d 620 (1981); *Bell Telephone Co.; Keystone Water Co., White Deer District v. Pennsylvania Public Utility Commission*, 477 Pa. 594, 385 A.2d 946 (1978).

Properly interpreted, the key language upon which OCA relies, that is, "nor otherwise included in the rates charged", serves to prohibit the inclusion of CWIP in rate base and safeguard against alternative ratemaking methods which seek to accomplish the same or a similar result. We believe that when the legislature added Section 1315, it codified the already existing PUC policy regarding the exclusion of CWIP in the rate base. We, in fact, have held that CWIP is not used and useful property and thus not entitled to a return until actually in service. *Bell Telephone Co.*

Act 335, adding Section 1315, was adopted following a controversy which involved the cost of constructing Philadelphia Electric Company's nuclear generating system on the Schuylkill River. It had requested the inclusion of $500,000,000.00 of the construction costs of the plant in rate base and proposed the removal of all restraints associated with the PUC policy of limited inclusion of CWIP in rate base. The PUC, however, rejected this claim and proposal as a matter of policy and affirmed its statutory authority to permit these

costs in rate base. *Pennsylvania Public Utility Commission v. Philadelphia Electric Company*, R-811626, May 21, 1982, 56 Pa. PUC (1982). In March, 1982 the Pennsylvania Senate passed a resolution expressing a viewpoint that the Code did not permit the inclusion of CWIP in rate base.[3] Act 335, adding Section 1315, was adopted on December 30, 1982, effective immediately, and was obviously meant to settle the issue regarding CWIP in accordance with the resolution.

In our view, the words and meaning of Section 1315 are not entirely clear. Under Section 1921(c) of the Statutory Construction Act, where the meaning of a statute is not explicit, the intention of the legislature may be ascertained by considering:

> (1) The occasion and necessity for the statute.
>
> (2) The circumstances under which it was enacted.
>
> (3) The mischief to be remedied.
>
> (4) The object to be attained.
>
> (5) The former law, if any, including other statutes upon the same or similar subjects.
>
> (6) The consequences of a particular interpretation.
>
> (7) The contemporaneous legislative history.
>
> (8) Legislative and administrative interpretations of the same statute.

1 Pa.C.S. § 1921(c). The legislature enacted the Act specifically to counter Philadelphia Electric Company's controversial request to include CWIP in rate base before the facilities actually served the public. By doing so, the legislature endorsed the longstanding PUC policy regarding treatment accorded CWIP rate base claims thereby codifying the exclusion of rate base in

[3]The resolution was implemented by the introduction of Senate Bill No. 1366, Session of 1982.

the cost of a facility before it has been completed or has begun providing service to the public.

We believe the PUC properly permitted the inclusion of the cost of the cancelled nuclear plants and, therefore, affirm its order.

1364 C.D. 1984

The OCA appeals an order of the PUC which permitted inclusion of the costs of four cancelled nuclear units and allowance of land held for future use in rate base by Penn Power. The PUC order also permitted normalization of tax benefits for state income tax purposes.

In July, 1983, Penn Power filed tariff revisions in order to increase annual revenues by $19,890,200.00. This request included additional return revenues resulting from inclusion of $842,074.00 in rate base of land held for future use, the amortization over ten years of Penn Power's $9,569,665 investment in four cancelled nuclear plants, and normalization of tax benefits associated with effects of depreciation in application to state income taxes. On April 11, 1984, the PUC adopted Penn Power's proposals for ratemaking purposes and this appeal followed.

Because we have resolved the issue regarding the amortization of Penn Power's investment in the nuclear plants, we need not further address it.

The OCA asserts that the PUC violated Section 1315 when it permitted an allowance of land held for future use in rate base because it provided a return thereon to Penn Power. This claim, the OCA maintains, involved electric utility facilities none of which could be deemed "used and useful" as contemplated by Section 1315. We disagree.

We reiterate that Section 1315 contemplates disallowing the inclusion of CWIP in rate base and further that the Code and decisional law uniformly apply "used and useful" only to rate base questions.

The OCA next contends that normalization of the tax benefits associated with state income taxes violates the "actual taxes paid" doctrine. The case of *Barasch, Consumer Advocate of Pennsylvania v. Pennsylvania Public Utility Commission and Pennsylvania Power Company*, — Pa. —, 491 A.2d 94 (1985), supports the OCA and we, therefore, reverse on the normalization issue.

PALLADINO, J., dissents.

No. 553 C.D. 1983

ORDER

Now, June 13, 1985, the order of the Pennsylvania Public Utility Commission, entered January 28, 1983, and April 18, 1983, at No. R-821945, is affirmed.

No. 1364 C.D. 1984

ORDER

NOW, June 13, 1985, the order of the Pennsylvania Public Utility Commission, entered April 11, 1984, at No. R-832409, regarding the inclusion of costs of cancelled nuclear plants and land held for future use in rate base, is affirmed and the order regarding normalization of actual state income tax expenses is reversed.

CRUMLISH, Jr., President Judge, concurring.

I agree with the able and articulate reasoning of the majority, but include an additional comment.

If we had concluded that Section 1315 extended beyond rate base and encompassed all components of rate structure, I would still have held it inapplicable to

the costs of these cancelled nuclear plants. This statute is only intended to prevent the inclusion in rates of construction work *in progress*. When construction is cancelled, a fortiori it does not progress. Section 1315's proscriptive effect attaches "*until such time* as the facility is used and useful. . . ." (Emphasis added.) The General Assembly's language unmistakably connotes a concept of delayed recoupment, not of total forfeiture, as would result if this provision barred recovery of costs associated with plants never to be completed.

Serious constitutional problems would be raised by precluding a utility from ever regaining monies prudently invested for the public benefit. Also, as alluded to by the majority, Section 1315 was enacted in response to a specific instance where a utility sought to charge rates for the costs of *ongoing* construction on a facility *scheduled for future completion*.[1] I would therefore construe Section 1315 as a provision concerned solely with construction work in progress.

COLINS, Judge, dissenting.

I must disagree with the conclusion by the majority in *Cohen v. Pennsylvania Public Utility Commission*, — Pa. Commonwealth Ct. —, 494 A.2d 58 (1985), that losses incurred by Duquesne as a result of expenditures on now-abandoned nuclear power plants should be borne by the consumer. Section 1315 of the Public Utility Code[2] clearly disallows the inclusion of the costs of construction of a facility in the rate base until it is used and useful, a practice already followed by the Public Utility Commission (PUC). But Section 1315 did not merely reiterate an existing PUC practice, but rather

[1] *See* majority opinion, at 62.
[2] 66 Pa.C.S. § 1315.

went on to state that these costs shall not be "otherwise included" in the rates charged until the facility is used and useful. Obviously, the legislature intended that the costs of CWIP's should not be included anywhere in the rates charged until the facility is being used.

Section 1921(a) of the Statutory Construction Act[3] states that "[e]very statute shall be construed, if possible, to give effect to all its provisions." Section 1921(b)[4] directs that "[w]hen the words of a statute are clear and free from all ambiguity, the letter of it is not to be disregarded under the pretext of pursuing its spirit." The interpretation given Section 1315 by the majority ignores a directive in the statute that "the cost of construction . . . of a facility undertaken by a public utility producing, generating, transmitting, distributing or furnishing electricity shall not be made a part of the rate base *nor otherwise included in the rates charged by the electric utility* until such times as the facility is used and useful in service to the public." (Emphasis added.)

The majority has misinterpreted the statute by ignoring the key phrase "nor otherwise included in the rates charged." The entire statute as it stands is not ambiguous. Any costs incurred in constructing a new facility by a public utility furnishing electricity cannot be included anywhere in its rates until that facility is actually providing utility service to its customers. If the legislature merely wished to codify a practice already utilized by the PUC in its rate computation, it would have simply disallowed the inclusion of these costs in the rate base. The legislature clearly intended that the costs of facilities which are not actually providing

[3] 1 Pa.C.S. § 1921(a).
[4] 1 Pa.C.S. § 1921(b).

service should not be borne by consumers anywhere in the rates paid until they are producing electricity.

Therefore, the decision of the PUC should be reversed.

MacPHAIL and PALLADINO, JJ., join.

APPENDIX C

Order of the Pennsylvania Public Utility Commission (Duquesne Light Co.)

Pennsylvania Public Utility Commission
v.
Duquesne Light Company

Intervenors: United States Steel Corporation, Office of Consumer Advocate, Pennsylvania Alliance for Jobs and Energy, Equitable Life Assurance Society of the United States, Joseph Horne Company, Kaufmann's, Gimbels, Gulf and Western Manufacturing Company, Armco, Inc., and Hospital Council of Western Pennsylvania

R-821945 et al.
January 27, 1983

APPLICATION *for authority to increase electric rates; granted as modified; income tax allowance reduced by hypothetical interest associated with accumulated deferred tax credits.*

By the COMMISSION:

Opinion and Order

I. *Introduction*

On April 30, 1982, Duquesne Light Company (respondent or Duquesne) filed, with the commission, Tariff Electric-Pa. PUC No. 15. The proposed tariff contained changes in rates, rules, and regulations designed to produce an increase in annual Pennsylvania jurisdictional electric revenues of approximately $165,013,000 based upon a future test-year level of operations for the twelve months ending December 31, 1982.

This proposed tariff was suspended by operation of law until January 29, 1983. By order entered June 4, 1982, we instituted this investigation at R-821945. Nine formal complaints were filed against the proposed rate increase and these were consolidated with our investigation for purposes of hearing, briefing, and disposition.[1]

[1]Four of the complaints were filed by commercial customers which are owners of buildings in downtown Pittsburgh, and are referred to herein as "commercial complainants." These are the Equitable Life Assurance Society of the United States, Joseph Horne Company, Kaufmann's and Gimbels.

The Hospital Council of Western Pennsylvania was granted intervenor status.

Twenty-four days of hearings were held in Pittsburgh and Harrisburg before Administrative Law Judge Joseph J. Klovekorn (ALJ). Duquesne presented twenty-three witnesses. The commission trial staff (staff) presented four witnesses as did the Office of Consumer Advocate (OCA). The commercial complainants and United States Steel Corporation (USS) each presented a witness in the area of rate structure.

Main briefs have been filed by Duquesne, staff, OCA, commercial complainants, USS, Armco, Gulf and Western, and the Hospital Council. Reply briefs were filed by all parties except USS and the Hospital Council.

The ALJ's recommended decision was issued on December 10, 1982. Exceptions were filed on or before December 20, 1982, by Duquesne, staff, OCA, commercial complainants, Armco, and the Pennsylvania Alliance for Jobs and Energy (PAJE). Replies to exceptions were filed on or before December 27, 1982, by Duquesne, staff, OCA, commercial complainants, and USS.

In addition to accomplishing disposition of this proceeding, this opinion and order completes the disposition of the respondent's petition regarding normalization of federal income taxes under the accelerated cost recovery system and also grants amortization of the respondent's cancellation costs arising from cancelled Central Area Power Coordination Group (CAPCO), construction which was the subject of investigation in the proceeding at I-79070315.

II. *Rate Base*

A. *Fair Value*

The respondent presented only original cost measures of value in this proceeding. Consequently, we shall adopt as the fair value of the respondent's rate base, the original cost measure of value as it shall be hereinafter determined.

B. *Electric Plant in Service*

Duquesne's claimed undepreciated original cost for electric plant in service on a *total company basis* as of the end of the future test year or December 31, 1982, is $2,246,044,570. This is based upon the reclassification of the plant accounts, effective December 31, 1936, as approved by the commission's orders of January 7, 1946, and February 9, 1948, at E.O.C. 10. Beginning January 1, 1938, the methods, procedures, and records for all property additions and retirements have been maintained in a manner compatible with the requirements of the basic plan approved by the commission. The company's continuing property records have also been maintained since that time in accordance with the approved CPR system. The Federal Energy Regulatory Commission (FERC) and the commission staff have periodically audited Duquesne's continuing records and related construction work order system and inspected its physical plant to ensure compliance.

The company's original cost measure of value contained in the original filing was predicated on the company's 1982 construction budget. During the course of the proceeding, numerous revisions, consisting of construction additions and deletions, changed in-service dates, revised construction costs, were made in the con-

struction programs reflected in the company's 1982 construction budget. Updated exhibits were filed to reflect these revisions.

Duquesne's claim is uncontested. We approve the claim.

C. *Depreciation Reserve*

Duquesne's claim for accrued depreciation (calculated reserve) applicable to its original cost—electric plant in service is $493,030,725, on a *total company basis*. In the last four Duquesne proceedings, we have approved Duquesne's estimated average service lives and survivor curves, and methodologies with respect to accrued depreciation for the transmission, distribution, and general plant accounts. In this proceeding Duquesne again prepared a life span analysis for all of its production plant, by unit. For each plant account, these exhibits set forth the original cost dollars, the probable retirement year of each unit, the estimated interim survivor curves, and the statistical support for each interim survivor curve. The depreciation calculations relating to production for each station are presented by plant account showing the original cost of the surviving plant by year of installation, the average life of the plant installed in each year, the annual accrual amount, the average remaining life expectancy, and the calculated reserve related to the original cost of each vintage.

The ALJ concluded that Duquesne's claim for accrued depreciation was supported by the uncontested evidence and recommended that it be accepted in this proceeding. We approve the claim.

D. *Additions to Rate Base*

1. *Property Held for Future Use and Other Items*

Duquesne has claimed $552,853, on a *total company basis*, for plant held for future use. This property consists of land with estimated in-service dates on or before 1988. No party has contested this claim. We find that the claim is reasonable and accordingly, it is allowed.

Duquesne has also claimed $61,482 as the undepreciated original cost of the used and useful plant of the Monongahela Light and Power Company. The associated depreciation reserve is $27,405. No party has contested this claim. We find the claim and the associated accumulated reserve to be reasonable and accordingly it is approved.

Additionally, Duquesne has claimed $355,000 as the undepreciated additional cost of the borough of Aspinwall plant, with an associated accumulated depreciation reserve of $275,125. No party has contested the claim and finding it otherwise reasonable, it is approved.

2. *Construction Work in Progress*

Duquesne's claim for electric plant in service reflects investment in plant which it expects to be in service at December 31, 1982. Additionally, it has claimed inclusion of construction work in progress (CWIP) with regard to certain nonrevenue-producing, regulatorily mandated projects, such as environmental control; and Nuclear Regulatory Commission (NRC) mandated projects. Duquesne's claim of $70,769,052, construction work in progress, on a *total company basis* is comprised of the following:

Construction Work in Progress (Net of Associated Retirements)	*Original Cost*	*Calculated Accrued Depreciation*
Environmental Control Projects	$52,479,898	$ 762,375
NRC Mandated	18,289,154	288,204
Claim	$70,769,052	$1,050,579

The company states that its claim reflects the estimated expenditures to complete the projects, all of which are expected to be in service during 1983, the year in which the rates to be set in this proceeding will be in effect. This claim, it urges, is consistent with allowances in other proceedings; citing Pennsylvania Pub. Utility Commission v Pennsylvania Power Co. R.I.D. 243, Jan. 27, 1977; Pennsylvania Pub. Utility Commission v. Dauphin Consol. Water Co. R-78050616, April 5, 1979; Pennsylvania Pub. Utility Commission v Philadelphia Electric Co. R-811626, May 21, 1982. These expenditures, it claims, are necessary for Duquesne to comply with environmental air and water pollution standards and NRC mandated requirements, in order to retain the existing capacity of generating stations already in service.

While not contesting the accuracy of the company's claim, the OCA opposes inclusion in rate base of any post-test-year expenditures. In support of its position, OCA cites our opinion and order in Pennsylvania Pub. Utility Commission v Penn Power, R-811510, Jan. 22, 1982.

The ALJ recommended approval of the respondent's claim. The OCA has excepted. We shall allow the claim based upon our decision in Pennsylvania Pub. Utility Commission v Philadelphia Electric Co. R-811626, May 21, 1982, wherein we distinguished a factual situation on almost all fours with the one present here, from that present in the Penn Power case. The essential feature of the claim here, which brings to within our policy of permitting the inclusion of pollution control and NRC mandated construction work in progress in rate base, is that the claim is limited to projects which will be in service within one year after the end of the future test year.

E. *Cash Working Capital*

Duquesne has submitted a cash working capital claim of $54,660,529, on a *total company basis*, as set forth below:

SUMMARY OF WORKING CAPITAL CLAIM

Operation and Maintenance Expense		$14,829,313
Prepayments:		
Prepaid Insurance	$1,477,277	
Prepaid Taxes—Real Estate	180,691	
Prepaid Federal Use Taxes on Highway Motor Vehicles	8,826	
Prepaid PUC Assessment	620,143	
Prepaid West Virginia Franchise Tax	513	
Prepaid Excise Tax	25,467	2,312,917
Deferred Rental under Nuclear Lease		20,596,196
Deferred Quarto Coal Cost		16,922,103
Total Cash Working Capital Requirement		$54,660,529

The staff proposes numerous adjustments to the company's claim. The staffs proposed cash working capital allowance is $13,450,086. The OCA also proposes numerous adjustments and an allowance of approximately $10 million. We will address each area of contention individually.

1. *Operation and Maintenance Expense—Lead-lag Study*

Duquesne's cash working capital claim associated with operation and maintenance expenses is based on a lead-lag study which uses 38.3 days for the average lag in the receipt of revenues and 24.5 days for the average lag in the payment of operating expenses.

The staff witness stated that the company's 38.3-day revenue lag includes a two-day allowance for processing and bank collection after receipt of payment, while, on the other hand, the 24.5-day expense lag claimed by the company includes only the period between the date goods and services are delivered or performed, and the

date of the check or disbursement voucher, no allowance being made for a disbursement float allegedly arising from mailing lag and bank processing.

The staff argues that if the lead-lag study is to include an allowance for disbursement float on the revenue side, it should also include an allowance for disbursement float on the expense side. The addition of a two-day expense lag to account for disbursement float would, according to the staff witness, decrease the cash working capital claim by $2.7 million.

The OCA would also reduce this claim by $2.7 million on the basis that this disbursement float amounts to the alternative equivalent of a claim for compensating bank balances.

Duquesne argues that the staff's adjustment erroneously assumed a two-day lag. It also states that the staff's proposed adjustment would recognize the same dollars which Duquesne has recognized by not claiming a compensating bank balance requirement, as the alternative to paying fees for banking services.

According to Duquesne's treasurer, R. G. Males:

"Checks are dated, entered in the cash book, and mailed the same day. The value of the checks mailed to the vendor and not yet presented for payment at the bank is disbursement float. A recent one-month analysis of cash disbursement indicates that 62.1 per cent of the total dollars expended during the month were processed through the bank account the same day entries were made to the cash book of the company. This is primarily attributable to sending large payments by bank wires. Bank wires are charged to the company's bank account on the same day the payment is sent and reduce both the bank ledger balance and collected bank

balance in the bank account. The remainder of the cash disbursements is disbursement float. For the month analyzed, January, 1982, $1,918,000 was disbursement float. Of the total cash disbursements for the month 14.1 per cent of the dollars was one-day disbursement float, 8.3 per cent was two-day, 9.9 per cent was three-day, with 5.6 per cent being four-day float or longer. As stated in the response to interrogatories of the consumer advocate, Set No. II, Item No. 2.20a last paragraph, the amount of the disbursement float is approximately equal to the amount of compensating balances required by the bank in 'payment' for demand deposit services. The company has made no claim for these required compensating balances. This is discussed in Duquesne Exh II, Item II-A-15, p. 2 of 2 and Item II-A-16e. The amount of the required compensating balances for demand deposit services is stated in Duquesne Exh II-A-16, p. 5, which is a portion of a copy of a letter from Roger N. Stanier, vice president of Mellon Bank. Should it be necessary to include the disbursement float in the calculation of the cash working capital expense lag days, it would then also be appropriate to include the amount of the disbursement float as a compensating balance requirement to be included in the cash working capital needs of the company."

It would appear from this record, therefore, that there is not a two-day lag, rather over 62 per cent of the total dollars expended during the month are processed the same day and have no lag. Duquesne states that the disbursement float which does exist is used to compensate the Mellon Bank for deposit and disbursement activity services. Such bank services normally require a fee or may take the form of a compensating balance requirement and such a claim has not been made here.

The record shows that the Mellon Bank would require some $1,980,000 in compensating balances for the deposit and disbursement activity services which it provided at the 1981 level.

The ALJ recommended that the proposed adjustment be rejected for two principal reasons: *First;* there is no support for the assumption that because there is a two-day revenue lag for processing and bank collection, there is a similar lag on the expense side. *Second;* the proposed adjustment fails to recognize that the disbursement float that does exist eliminates the need for a compensating balance requirement.

Both the staff and the OCA except. The proposed adjustments are rejected and the exceptions are denied. We have previously recognized that it is appropriate to offset disbursal float against compensating balance requirements (Pennsylvania Pub. Utility Commission v Pennsylvania Power Co. R-815510, Jan. 22, 1982). Here the waiver of a compensating balance claim constitutes the same result.

2. *Expense Payment Lag for Net Energy Clause Expenses*

Office of Consumer Advocate witness, Henkes, proposed reducing the company's cash working capital claim by $1,759,000 to reflect the expense lag associated with net energy clause energy expenses. The ALJ recommended that this adjustment be rejected: *First,* on the basis that Duquesne includes in its calculation, dollars associated with demand charges which Duquesne is not permitted to collect through its net energy clause and, therefore, to the extent those costs are in excess of the amount in base rates; dollars which it never recovers from its customers. *Second;* on the basis that the purchased power dollars (sales) are a net amount

and reflect sales of power by Duquesne to other companies, which at some subsequent point in time pay Duquesne for this power either in cash or in equivalent power. These dollars are reflected in the net energy clause as a credit to the customer when the power is delivered, not when they are actually paid. The OCA has excepted. The exception is denied. We conclude that the proposed adjustments are inappropriate for the reasons proffered by the ALJ.

3. *Prepayments*

Duquesne's claim with respect to prepayments of $22,312,917 is calculated on the basis of a 13-month average balance and is detailed in Duquesne Exh No. III, Item No. III-A-14. The claim is uncontested. The ALJ recommends its allowance. We find the claim reasonable and accordingly it is approved.

4. *Deferred Rentals under Nuclear Lease*

The company's claim of $20,596,196 for deferred rental under its nuclear fuel lease includes (i) $11,691,099 related to fuel presently in the reactor, (ii) $5,848,344 associated with the next reload, the fabrication of which will be completed before the rates in this proceeding will be in effect, and (iii) $3,056,753 for nuclear fuel still in process. The ALJ recommended approval of the first two items and disapproved of the third item.

The staff urges that that portion of deferred rental under its nuclear lease associated rental under its nuclear lease associated with nuclear fuel still in process (Items ii and iii above) be excluded from cash working capital allowance. It, therefore, proposed reducing the company's claim by $8,905,097. The OCA proposed a similar adjustment.

The issue of rate base treatment for nuclear fuel in process was recently considered in our opinion and order in Pennsylvania Pub. Utility Commission v Philadelphia Electric Co. R-811626, May 21, 1982. There we approved a claim for the company's investment in nuclear fuel in process. The company relies on that opinion and order to support its present claim.

There was no opposition to the inclusion in cash working capital of the $11,691,099 in rentals related to the fuel currently in the reactor. The ALJ recommended approval of this portion of the claim. No party excepted. We find this claim appropriate and accordingly, it is approved.

The objections to inclusion of the $5,848,344 associated with the next reload seem minor. Staff notes that this fuel will not be delivered until February, 1983, "well beyond the end of the 1982 test year." The OCA argues that there is no assurance that this fuel load will occur as currently scheduled. We know, however, that Beaver Valley will require a reload sometime shortly after these rates go into effect. Further, the delivery date is only a matter of some weeks past the end of the test year. This amount shall be allowed. Accordingly, the exceptions of the staff and OCA are denied.

With respect to the remaining $3,056,753, representing rentals on fuel in process, the ALJ recommended disallowance based upon the absence of the special circumstances which we found present in our opinion and order in Pennsylvania Pub. Utility Commission v Philadelphia Electric Co. R-811626, May 21, 1982. We stated there that:

"*Based upon the particular circumstances of this case and our determination that Limerick Unit No. 1 is in the public*

interest and is to be completed in the near future, we are of the conviction that recovery of the investment in nuclear fuel in process, other than that associated with Limerick Unit No. 2, is in the best interest of both the ratepayers and the company. We find merit in PECO's argument that a guaranteed fuel supply and avoidance of spot market purchases benefits both current and future ratepayers." (Emphasis added.)

We agree with the ALJ that those special circumstances are not present here. We conclude that the company's claim for deferred rentals for the remaining nuclear fuel in process should not be allowed for the reasons which we stated in our opinion and order in Pennsylvania Pub. Utility Commission v Pennsylvania Power Co. R-811510, Jan. 22, 1982, which was that this expense is most analogous to deferred energy costs, and that our long-standing policy is to allow a return on "used and useful" property but not on operating expenses. The company's exception is, accordingly, denied. As an alternative to inclusion in rate base, we shall permit, as suggested by the OCA, the company to accrue allowance for funds used during construction (AFUDC) on the disallowed sum of $3,056,753, in the manner and for the period set forth in the pertinent ordering paragraph.

5. *Accumulated Interest and Preferred Dividends Offset*

Although recognizing that in its rate proceeding, at R-80011069, we offset its cash working capital claim by an amount equal to its accumulated debt interest and preferred and preference stock dividends, Duquesne did not make such an adjustment here. The adjustment proposed by the staff for these items totals $12,622,000. The OCA proposed a similar adjustment although different in amount from the staff ($12.8 million).

Duquesne states that there is no actual basis for such an adjustment. It asserts that the basis for a cash working capital adjustment for accumulated interest expense and accumulated preferred stock dividends should be no different than any other aspect of a lead-lag study. That is, such an offset, is only appropriate where the recovery of interest and dividends from ratepayers actually leads the disbursement of such interest and dividends to the investors.

Duquesne then states that the evidence in this record shows that, rather than the interest expense and preferred stock dividends being collected by the company from ratepayers prior to disbursement to Duquesne's investors, interest expense and preferred stock dividends are, in fact, paid by Duquesne to the company's investors well in advance of any payments received from Duquesne's ratepayers. In other words, Duquesne claims that receipt of the payments from ratepayers lag the actual cash payments to company's investors, a lag for which, Duquesne says, it has never sought compensation.

Interestingly, we note that Duquesne's witness Mr. Ellenberger acknowledged that in our opinion and order at R-80011069, we rejected this identical argument. Nonetheless, Duquesne pursues this matter yet again, citing a decision of the supreme court of the state of Rhode Island, which reversed a similar adjustment by the Rhode Island commission, on the basis that accumulated interest are investor-supplied funds, urging us to follow that decision. We are unpersuaded that such is the law in this commonwealth. This issue has been litigated by various utilities since an adjustment was first made by the commission in 1978. To date we

have made such an adjustment in at least 18 proceedings[2] and we have consistently been affirmed by the commonwealth court.[3] The ALJ recommends the adoption of an adjustment which was recalculated based upon his adopted rate base.

The respondent has excepted. The exception is denied and we will reduce the cash working capital claim, by $12,674,000, based upon our adopted rate base, which amount is identical to that calculated by the ALJ. Because of this identity of result, no commission adjustment to the ALJ's adopted rate base appears in Table II [omitted herein].

[2]Pennsylvania Pub. Utility Commission v Philadelphia Electric Co. R-811626, May 21, 1982; Pennsylvania Pub. Utility Commission v Pennsylvania Electric Co. R-811510, Jan. 22, 1982; Pennsylvania Pub. Utility Commission v Philadelphia Electric Co. R-80061225, April 24, 1981; Pennsylvania Pub. Utility Commission v Pennsylvania Gas & Water Co. R-80071235, April 24, 1981; Pennsylvania Pub. Utility Commission v. Duquesne Light Co. (1981) 54 Pa PUC 695, 43 PUR4th 27; Pennsylvania Pub. Utility Commission v West Penn Power Co. (1981) 54 Pa PUC 602; Pennsylvania Pub. Utility Commission v Pennsylvania Power & Light Co. (1981) 54 Pa PUC 645; Pennsylvania Pub. Utility Commission v National Fuel Gas Distribution Corp. (1980) 54 Pa PUC 401, 40 PUR4th 101; Pennsylvania Pub. Utility Commission v Carnegie Gas Co. R-79100981, July 25, 1980; Pennsylvania Pub. Utility Commission v Philadelphia Suburban Water Co. R-78040824, Feb. 1, 1980; Pennsylvania Pub. Utility Commission v West Penn Power Co. (1979) 53 Pa PUC 410, 32 PUR4th 245; Pennsylvania Pub. Utilitv Commission v Pennsylvania Electric Co. (1979) 53 Pa PUC 203; Pennsylvania Pub. Utility Commission v Metropolitan Edison Co. (1979) 53 Pa PUC 225, 28 PUR4th 555; Pennsylvania Pub. Utility Commission v Pennsylvania Power Co. (1978) 52 Pa PUC 457, 27 PUR4th 426; Pennsylvania Pub. Utility Commission v Philadelphia Electric Co. (1978) 52 Pa PUC 772, 31 PUR4th 15; Pennsylvania Pub. Utility Commission v Peoples Nat. Gas Co. (1978) 52 Pa PUC 616, 28 PUR4th 180; Pennsylvania Pub. Utility Commission v Pennsylvania Electric Co. (1978) 51 Pa PUC 649; Pennsylvania Pub. Utility Commission v UGI Corp. (1978) 52 Pa Puc 383.

[3]Philadelphia Electric Co. v Pennsylvania Pub. Utility Commission (1981) 62 Pa Cmwlth 325, 433 A2d 620; UGI Corp. v Pennsylvania Pub. Utility Commission (1980) 49 Pa Cmwlth 69, 410 A2d 923; Peoples Nat. Gas Co. v Pennsylvania Pub. Utility Commission (1980) 52 Pa Cmwlth 201, 415 A2d 937; Penn Electric Co. v Pennsylvania Pub. Utility Commission (1980) 53 Pa Cmwlth 186, 417 A2d 819.

6. *Deferred Quarto Coal Costs*

A portion of the coal requirements for the Mansfield units, which are owned in part, by Duquesne, is supplied from the Quarto mine. On December 11, 1980, we instituted an investigation at I-80120343 regarding the reasonableness of the cost of coal from this mine. On January 12, 1981, we entered an interim order providing:

"[t]hat for purposes of calculating the current net energy clauses of Duquesne Light Company and Pennsylvania Power Company, the companies shall limit pricing of Quarto coal to market prices determined by the same methodology used prior to removing the mines from development; such limitation shall commence upon entry of the order and shall remain in effect until that instant investigation is concluded, or until otherwise ordered by the commission.

"That Duquesne Light Company and Pennsylvania Power Company shall defer collection of the cost of the Quarto coal that may be uncovered as a result of Ordering Par No. 1, pending the termination of the instant investigation."

Duquesne's cash working capital claim includes $16,922,103 for deferred Quarto coal costs. The company argues that these coal costs were reasonably incurred and its inability during the continuance of the investigation to pass on to its customers the full costs incurred by it for such coal does not change this fact. Duquesne then argues that the carrying costs created by the deferrals are busines costs incurred by it, no different than other investor-supplied expenditures.

The staff and the OCA oppose this claim. They argue that by including those costs in its cash working capital claim, Duquesne is requesting a current return on costs

that are now under investigation and may be found to be excessive and unreasonable.

The ALJ recommends disallowance of this claim, at least pending completion of the investigation.

The respondent has excepted. We adopt the proposed adjustment and deny Duquesne's exception. Our interim order of January 12, 1981, effectively questioned the reasonableness of those costs which were required to be deferred. It would be inconsistent for us to permit a return on such deferred costs, by permitting their inclusion in rate base.

7. *Customer Deposits*

The OCA proposes a $1.7 million deduction to reflect the elimination of customer deposits from rate base, and proposes that interest on customer deposits be included as an above-the-line expense. Duquesne opposes the adjustment as a change without substance, and urges that the adjustment be rejected, as was done in the proceeding at R-811470. In that proceeding, the adjustment proposed by the Pennsylvania Alliance for Jobs and Energy was rejected, because of a failure to address the subject of the treatment to be accorded the associated interest expense. Here the OCA proposes a concomitant interest expense adjustment. The ALJ recommends adoption of the proposed adjustment. We agree that such an adjustment is appropriate, and Duquesne's exception is denied. It is well established investors should not be permitted to earn a return on funds which they do not supply. Conversely, the interest that Duquesne pays on such amount is a legitimate business expense for which it should be made whole. We shall, therefore, make the concomitant adjustment for interest expense.

F. *Other Working Capital*

1. *Materials and Supplies*

As shown in Duquesne Exh No. 1B, p. F-2, Duquesne's total working capital claim includes a materials and supplies (other than fuel) inventory claim of $29,123,728 based upon the 13-month average budgeted balance of the materials and supplies inventory. No party has contested this claim.

The company's materials and supplies working capital claim is consistent with the commission's tariff regulations which specifically request the monthly materials and supplies book balances for the thirteen months prior to the end of the test year. (52 Pa Code, § 53.53, item I-A-15.)

The ALJ includes [sic] that Duquesne's materials and supplies working capital claim of $29,123,728 is reasonable and recommends approval of its claim. We agree and approve the claim.

2. *Fuel inventory*

As shown in Duquesne Exh No. 1B, p. F-1, Duquesne's working capital claim includes a fuel on hand claim of $44,537,267 for coal and oil in inventory. This figure was based upon adjusted test-year conditions as to load distribution for assumed Beaver Valley Unit No. 1 operation under conditions comparable to a 63.6 per cent capacity factor and Shippingport shutdown all year. No party to the proceeding has submitted evidence contesting this claim.

The company's fuel inventory claim is consistent with the commission's regulations which specifically request the monthly fuel on hand balances (quantity and price) for the thirteen months prior to the end of

the test year (52 Pa Code, § 53.53, Item I-A-16). In previous proceedings we have allowed similar claims. See, e.g., Pennsylvania Pub. Utility Commission v Pennsylvania Power & Light Co. (1981) 54 Pa PUC 645; Pennsylvania Pub. Utility Commission v Duquesne Light Co. (1981) 54 Pa PUC 695, 43 PUR4th 27.

Duquesne's fuel on hand working capital claim of $44,537,267 is reasonable and it is approved.

G. *Conclusion*

Our adopted fair value rate base on a Pennsylvania jurisdictional basis, is $1,779,313,000.

We should note for the benefit of the reader that no party contested the company's proposed rate base reduction applicable to sales for resale under the jurisdiction of the Federal Energy Regulatory Commission. We approve that jurisdictional allocation without additional comment herein.

III. *Operating Revenues*

Duquesne estimated its test-year *total company*, operating revenues at present rates at $693,113,000, which includes a number of adjustments, most of which were uncontested. Additionally, the staff proposed one adjustment. These shall be addressed seriatim.

A. *Uncontested Adjustments*

Seven adjustments by Duquesne to its estimated operating revenues were uncontested by the parties. These were:

(1) A reduction of $33,310,000 to eliminate the state tax adjustment Rider 10 revenues;

(2) A reduction of $134,590,000 to eliminate the energy cost rate revenues;

(3) An increase of $3,796,000 to reflect the estimated additional revenues resulting from annualizing the increase in the number of customers during the test year;

(4) An increase of $1,266,000 to reflect the estimated additional revenues resulting from annualizing the increase in use per customer during the test year;

(5) An increase of $18,000 to reflect the estimated additional revenues resulting from annualization of late payment charges to reflect increases in number of customers and increases in usage per customer;

(6) An increase of $3,000 to reflect the estimated revenue from the residential conservation program for the test year. (Although this estimate was reduced to $1,785 in Duquesne Exh No. 313-4 the claim was not revised); and,

(7) An increase in miscellaneous service revenues of $93,000 to reflect the revenues expected to result from the proposed returned check and reconnection charges.

These uncontested adjustments and the amount thereof appearing to be reasonable are accepted.

B. *Sales to Crucible Steel*

Duquesne reduced test-year revenues by $18,649,916 to reflect the loss of sales associated with the shutdown of Crucible Steel's Midland plant which occurred during the future test year but which was unanticipated when the 1982 budget was prepared. The reduction of $18,649,916 is a net amount; that is, the annualized budget revenue for the Midland plant of $26,696,696, less the amount of $8,046,780 expected to be recovered under the demand ratchet provisions of Duquesne's tariff. This adjustment was based upon an estimated loss of 693,880,000 kilowatt-hours of sales, which in turn

was based upon annualized sales, predicated upon the then highest demand months of 1981.

The staff contested the Duquesne proposal with a proposed alternative adjustment of $15,814,395. The staff's proposed downward adjustment of $2,835,521 to Duquesne's proposed adjustment is accompanied by a concomitant adjustment (increase) in operating expenses of $933,739.

The difficulty encountered with regard to an adjustment for the closing of Crucible Steel's Midland plant, is that while the 1982 budgeted sales estimates contains a projected sales estimate of 4,430 million kilowatt-hours for the seven largest steel producers, it does not contain an individual figure for Crucible Steel's Midland plant. While the company's adjustment was based upon the highest three-month demand period of June to August, 1981, the staff's proposed adjustment was based upon the demands for the eight-month period of May to December, 1981.

In rebuttal the company, through its witness Dudt, attempted to bolster its proposed adjustment by pointing out that its 1982 sales estimate of 4,430 million kilowatt-hours for all seven steel producers, prepared in late September or October, 1981, is compatible with the February 12, 1981, estimate prepared by the industrial service department of 4,400 million kilowatt-hours, of which Crucible Steel sales at the Midland plant represented 775 million kilowatt-hours. Therefore, reasons Mr. Dudt, the 1982 budgeted sales estimate reasonably could have included as much as 780 million kilowatt-hours of sales for the Midland plant, as contrasted with Duquesne's proposed adjustment based upon 694 million kilowatt-hours of sales.

We are confronted with what is essentially a budget forecast of sales to the seven largest steel producers of 4,430 million kilowatt-hours, prepared by Data Resources, Inc., based upon "outputs" and peaks that are developed in the official load forecasts[4] prepared in September or October, 1981, and a similar estimate of 4,400 million kilowatt-hours prepared some months earlier, in February, 1981, based upon an unknown methodology. Based upon the similarity of results we are asked to accept that the ingredients are reasonably the same and that the 1982 budget estimate of sales includes 775 or 780 million kilowatt-hours of sales for the Crucible Steel Midland plant. We cannot accept this type of reasoning and the conclusion urged upon us by Duquesne.

The question posed by staff counsel at Tr. p. 169 was most pertinent. That question was: "Isn't the real question here, Mr. Maxwell, what was in the budget for Crucible Steel not what's a reasonable load for Crucible Steel?" However, it appears that we do not have an acceptable answer to the first portion of the question and must be satisfied with an answer to the second portion of the question. In examining Duquesne's adjustment methodology as contrasted with that of the staff, we find nothing to commend it over the staff's methodology, insofar as validity is concerned, and therefore, we conclude that Duquesne has failed to meet its burden of proof with regard to this adjustment.

Duquesne excepted to the ALJ's recommendation of the staff's proposed adjustment. Having concluded that Duquesne failed in its burden to establish that its adjustment was more appropriate, its exception is denied.

[4]This is an oversimplified description of an estimating process the description of which is contained in approximately 30 pages of text, tables, and diagrams in Exh 1, Item 1-B-6-8.

C. *General Public Utili[illegible] Revenues*

Duquesne adjusted future test-year revenues downward by $720,000 to eliminate revenues received by the company pursuant to the CAPCO basic operating agreement as an indirect participant in capacity and energy sales from Ontario Hydro to General Public Utilities (GPU). The company argues that it has no control over the GPU/Ontario Hydro agreement, which may be canceled at any time by mutual agreement of the parties, and therefore, it cannot be certain that it will actually receive such revenues.

The staff and the OCA oppose this adjustment. Staff argues that there is no evidence on this record that the contract with Ontario Hydro has been canceled or is about to be canceled. Moreover, no evidence exists in this record to support the view that GPU's purchased power requirement would be reduced in the near-term future. As of the close of this record, that contract is still in effect and producing revenues for Duquesne. The ALJ recommended that the staff's position be adopted and the company's claimed operating revenues be increased by $720,000 to account for the Ontario Hydro transaction.

Duquesne has not excepted, and failing to perceive any factual basis for Duquesne's proposed adjustment, it is rejected. Estimated operating revenues will be increased accordingly.

D. *St. Joe's Mineral Corporation Purchases and Sales*

Staff proposed an increase of $211,800 in operating revenues as a result of sales of power purchased from St. Joe Minerals Corporation, which is eventually sold to General Public Utilities through the CAPCO system.

Of the revenues of $35,300 per month projected by Duquesne approximately one-half are credited through the energy cost rate, leaving the annualized amount of $211,800 not presently reflected as revenues. Although Duquesne did not address this subject in its briefs, the apparent reason for not including the revenues in its estimates is the uncertainty of the continuation of the arrangement through 1983. The ALJ recommended adoption of the staff's proposed adjustment. Duquesne has not excepted. Finding the staff's proposed adjustment reasonable and appropriate, it is adopted. Revenue estimates will be accordingly adjusted.

E. *Deductions from Rate Base*

Accumulated Deferred Income Taxes

The respondent has proposed *a total company* deduction from rate base of $136,980,140 by reason of accumulated deferred income taxes. No party has questioned the appropriateness of this amount. The amount appearing reasonable, it is adopted as the proper deduction from rate base by reason of accumulated deferred income taxes.

IV. *Expenses*

Duquesne's estimated operating expenses, as of December 31, 1982, were adjusted to reflect annualization to the level of operations at December 31, 1982. Based upon such pro forma levels of operations, Duquesne's operating expense claim (excluding income taxes) is $472,632,000, which amount reflects the elimination of $125,361,000 of energy cost rate related expenses. The various individual adjustments are discussed seriatim.

A. *Operation and Maintenance*

1. *Wages, Pensions, and Employee Benefits*

Duquesne included in its pro forma level of operations, additional operations and maintenance expenses to: (1) annualize the effect of wage increases to various groups of employees (increases effective October 1, 1982, pursuant to the International Brotherhood of Electrical Workers [IBEW] contract and merit increases to non-union employees effective on the same date); (2) annualize the increase in pension and other employee benefits applicable to the salary and wage increases of October 1, 1982; and (3) to annualize charges by operators of jointly owned generating stations for increases in wages and fringe benefits for employees at each station.

After noting that Duquesne is increasing wages by 10.05 per cent in 1982, staff "suggests that some recognition should be given to the current economic climate with respect to wage increases by moderating the amount of the claimed wage increases for rate-making purposes." The ALJ rejected this suggestion emphasizing that a speculative wage adjustment was not included, but, rather, a known wage increase, effective October 1, 1982, pursuant to the respondent's contract with the International Brotherhood of Electrical Workers.

The staff excepted to the ALJ's conclusion and referred to a similar adjustment made by the Wisconsin Public Service Commission in a Wisconsin Electric Power rate case. Upon examination, we find that the Wisconsin commission held that the *projected 8.20 per cent wage increase* was unreasonable in light of the smaller wage settlements being negotiated by unregulated firms (*Electric Week*, November 29, 1982). Du-

quesne has replied by contending that this was the second year of the contract, which Duquesne would be required to break if the adjustment suggested by staff were made.

We concur with the ALJ's disposition of the adjustment proposed by the staff. Its proposed wage expense adjustment to reflect "current economic conditions" has not been supported by any record evidence. The staff has not presented specific evidence which would indicate that the subject wage increase is excessive.

2. *Rate Case Expense*

Duquesne's rate case expense claim in this proceeding is comprised of an amount related to the current proceeding and amounts related to prior proceedings before this commission. With respect to the expenses for the current proceeding, the respondent has claimed a "normalized" annual level of $600,000.[5] The respondent's prior proceeding claim of $151,328 is based on the unrecovered costs associated with RID 198 and RID 373 and the unrecovered amount associated with R-79010740, amortized over five years.

The staff contends that the respondent's claim is "grossly inflated" and "inconsistent" with prior commission decisions which establish clear commission policy in this area. The staff relies upon Pennsylvania Pub. Utility Commission v Pennsylvania Power Co. R-811510, pp. 21–23, Jan. 22, 1982, in arguing that the following commission policy on rate case expense has been established:

[5]As Duquesne notes in its main brief, it did not adjust operating and maintenance expenses in its final income statement to reflect a $100,000 increase from its original estimate of rate case expenses at Duquesne Exh No. 1B, Note 15, p. 111.

"First, the unrecovered portion of prior rate case expenses is to be amortized over ten years, after which that component ceases to be a factor in the rate-making process. Second, the normalized level of rate case expense is to be shared equally between ratepayers and stockholders. Third, the normalized level is determined on a case-by-case basis, although two years is typically used to develop the normalized amount."

Based upon these supposed guidelines, staff proposed a total rate case allowance for Duquesne amounting to a maximum of $176,264 calculated as follows:

(a) $26,264 to continue the ten-year amortization of prior rate case expenses established in Duquesne's recent rate case at R-80011069 for the unrecovered expenses associated with all prior rate cases; and,

(b) $150,000 based on a $600,000 rate case expense, normalized over two years and shared equally between ratepayers and stockholders.

The staff contends further, that the commission concluded in the opinion and order in R-80011069 that there was no unrecovered rate case expense associated with the settled rate case at R-7910740. Pennsylvania Pub. Utility Commission v Duquesne Light Co. (1981) 54 Pa PUC 695, 43 PUR4th at pp. 53, 54.

The OCA recommends a total rate case expense allowance of $271,450. Mr. Henkes, the OCA witness, (1) referred to the opinion and order at R-80011069 and did not recognized any amortization for the rate case expense incurred in the respondent's prior rate proceeding at R-79010740; (2) advocated a ten-year amortization of the unamortized rate case expense balances from prior proceedings; and, (3) reduced the $500,000 normalized

annual level of rate case expenses by $250,000 to reflect a 50/50 sharing of such expense between ratepayers and stockholders.

Duquesne contests the disallowance of its claimed unrecovered rate case expense from the 1979 proceeding (R-79010740), arguing that it is unfair and inconsistent with sound rate-making principle to disallow the claimed unrecovered rate case expenses merely because the case involved a settlement, especially when the staff had recommended therein the recovery of $498,853 over a five-year period. Therefore, Duquesne claims this amount in the current proceeding, as a portion of the unamortized rate case expense to be amortized over five years. Duquesne has claimed the amount of $542,153, for that proceeding, contending that this was the actual cost, rather than the cited staff figure, arguing that none of it will have been recovered as of the end of the future test year. This translates into a rate case expense claim of $108,430.60 ($542,153 ÷ 5) for the unrecovered costs associated with R-79010740.

Although acknowledging that in our opinion and order at R-80011069, we also directed that the unrecovered rate case expense balance be amortized over a ten-year period, the respondent's claim reflects a five-year amortization of the unrecovered balance.[6] Duquesne argues that this is a more equitable period, considering the fact that these expenses began to be incurred more than five years ago and that the commission has refused to include the unamortized amounts in its working capital, rate base claim.

[6]As of December 31, 1982, Duquesne claims an unamortized balance of $214,489, for the proceedings at RID 198 and RID 373. Our unamortized balance is calculated in footnote 7.

Finally, the respondent contests the 50/50 sharing of rate case expenses between the ratepayers and the stockholders. Duquesne submits that these expenses are a reasonable and legitimate cost of doing business and not a cost properly to be borne by investors. Duquesne also asserts that its current rate case claim of some $600,000 is reasonable and should be allowed.

The ALJ rejected the respondent's rate case expense claim of $651,328 and adopted staff's recommendation of a $176,264 allowance for rate case expenses in this proceeding. This total rate case expense allowance of $176,264 consists of $26,264 representing the continued ten-year amortization of past rate case expenses and $150,000 to reflect the normalized amount of current rate case expenses. In arriving at his recommendation, the ALJ found the arguments raised by Duquesne to be an insufficient basis upon which to depart from the treatment accorded to rate case expense in our previous decisions.

Duquesne excepts to the ALJ's recommendation. In its exceptions, the respondent again submits that the disallowance of any amount of rate case expense incurred in the proceeding at R-79010740, is grossly unfair and inconsistent with sound ratemaking principles. Furthermore, they argue that a ten-year amortization of prior rate case expense is an unreasonably long period. With respect to the current rate case expense and the ALJ's adoption of a two-year normalization period, the respondent contends that based upon rate increase filings in each of the last four years a more reasonable normalization period is one year. Finally, the respondent submits that Administrative Law Judge Mindlin's recommended decision at R-811819 (the Bell Telephone Company of Pennsylvania), dated August 6, 1982, cor-

rectly summarizes the fallacy of an equal sharing of rate case expenses between ratepayers and stockholders and his reasoning should be followed in this proceeding.

With regard to our conclusion, as expressed in our opinion and order in the proceeding at R-8001109, that there was no unamortized rate case expense arising from the proceedings at R-79010740, Duquesne did not seek revision of our conclusion in its petition for reconsideration and clarification filed therein on March 6, 1981. However, in essence, its claim here seeks reconsideration of that decision. While we might reject its claim here for untimeliness, we have considered the merits of its claim, and conclude again that our decision in our opinion and order in the proceedings at R-80011069 was correct, and we affirm our prior decision on this subject.

With regard to the amortization period of ten years, adopted in the proceeding at R-80011069, in this proceeding, Duquesne has requested reamortization of past rate case expense over a five-year period. We have reconsidered this matter and will grant its request. This will result in an allowance of $42,460 for amortization of past rate case expenses.[7]

With regard to current rate case expense we find the revised claim of $600,000 to be a reasonable level of expense. We have closely examined Duquesne's contentions with regard to the reasonableness of our past practice of adopting a 50/50 sharing of these costs between ratepayers and stockholders and being unpersuaded that it is either unreasonable or unwise we adhere to our recent practice of sharing the burden of these costs. With regard to the period to be adopted to

[7]Initial balance $262,640 – 23/120 of $262,640 or $50,340 = 212,300 ÷ 5 = $42,460.

determine a proper normalization allowance, Duquesne has argued, based upon recent proceedings, that a one-year period should be adopted. While we note that its rate increase applications have been filed on an almost annual basis, based upon recent developments with regard to inflation rates, the cost of money, and wage settlements, we conclude that two years is a reasonable expectation for the life of rates to be established herein. Consequently, we adopt a two-year period and will allow $150,000 as a reasonable normalized expense.

Our total allowance therefore is $192,460 which constitutes a disallowance of $458,868 of the amount claimed.

3. *Shippingport Expenses*

The Shippingport atomic power station was removed from service on October 1, 1982. By opinion and order adopted October 15, 1982, at P-820388, we approved Duquesne's petition to retire Shippingport.

Duquesne made two test-year adjustments to reflect the removal of Shippingport from service. The first adjustment reduced production operations and maintenance expenses by $2,839,000 to reflect the cessation of operation. No evidence was submitted by other parties contesting this adjustment and the ALJ adopted the proposed adjustment. We find the adjustment to be reasonable and adopt the ALJ's recommendation.

The second adjustment provides for the amortization over a ten-year period, of the unamortized balance of investment in Shippingport. The estimated undepreciated original cost of the unit will be $12,720,855. This balance, after further adjustments, including credits for accumulated deferred income taxes, will amount to

$4,728,160. Duquesne seeks to amortize the $4,728,160 over a ten-year period for an annual recovery of $472,816.

The staff and the OCA oppose this adjustment in part. The staff contends that Duquesne has included a $771,898 claim for the unrecovered depreciation associated with the periods prior to 1978, with the bulk of those unrecovered depreciation expenses ($687,000) relating to the period April, 1967, through June 1970. The staff argues that current ratepayers should not be burdened with depreciation expenses that could have been claimed more than ten years ago.

Duquesne argues that it has booked substantially greater dollars than it has been reimbursed by ratepayers, with the difference between book depreciation and reimbursed depreciation, during the 1969-77 period, being primarily due to the lapse of time between the test-year-end and the effective date of increased rates. According to the respondent, the exclusion from the amortization of the unrecovered prior period depreciation will result in Duquesne never recovering the full cost of the Shippingport station.

The staff asserts that regulation does not guarantee the recovery of every dollar of expense incurred by a utility and that it must be recognized that certain costs may not be recovered and may remain unrecoverable, as an incident of regulation. This is a risk which stockholders bear. The OCA witness, Mr. Henkes, argued that "sound regulation is prospective in nature and prospective regulation should not serve to make up for regulatory lag experienced in the past."

The ALJ agreed with the staff and the OCA reasoning, that respondent was never precluded from increas-

ing its claims for depreciation expense during this period. Since this expense could and should have been claimed over ten years ago, the ALJ recommends not burdening current ratepayers with this depreciation expense claim. The ALJ effectuated this recommendation by adjusting the claim, eliminating that portion of the Shippingport amortization claim which represented recovery of pre-1978 depreciation, thereby reducing Duquesne's claimed test-year operating expenses by $77,200 ($771,898 per ten years).

The respondent excepted to the ALJ's recommendation. Duquesne states that its depreciation expense adjustment has already accorded ratepayers the full benefit of the accumulated deferred tax reserve, despite the fact that the full amount of this deferral was never funded by ratepayer revenues. Thus, the respondent contends, the ALJ's adjustment gives the ratepayers a double benefit.

We concur with the ALJ's recommended disallowance of $77,200 of the Shippingport amortization claim. The essence of this claim is Duquesne's contention that the depreciation expense component contained in the rates charged to, and revenues received from ratepayers, represented less dollars of expense than was booked by the company. Duquesne states that this alleged underrecovery of depreciation expense was the result of regulatory lag; that is, the lapse of time between the end of the particular test year and the date that increased rates became effective. However, examination of Mr. Heller's testimony reveals that by far the vast majority of the claimed deficiency is the result of the company commencing the booking of depreciation in 1959 and the plant not being recognized in rate base until the fall of 1970. Additionally, there appears to be an

error claimed in the company's claimed depreciation reserve in the proceeding at R-811470, which was terminated by an "option order" rate increase filing.

Reduced to its bare essentials, the result which Duquesne seeks to achieve is to operate a plant for over ten years, during which time it has booked depreciation, and then over twenty years from the date it went into service request recovery of the difference between the depreciation booked and that depreciation expense supposedly recovered to rates. A necessary premise to Duquesne's claim is that until a specific plant is explicitly recognized in a given set of tariff rates, it does not recover any depreciation expense applicable to that plant. In our view this premise is not valid. It is entirely possible that in a period of expanding sales, increased revenues match and even exceed the increased depreciation expense applicable to new plants placed in service to provide the increased kilowatt-hours of sales. Insofar as the claim relates to an error in the claimed depreciation reserve in the proceedings at R-811470, we decline to consider what amounts to an after-the-fact reconsideration of that proceeding, especially where the proceeding terminated in "option order" rates.

In our order in Pennsylvania Pub. Utility Commission v National Fuel Gas Distribution Corp. ([1980] 54 Pa PUC 401, 40 PUR4th 101), we were considering a somewhat analogous claim and said:

"In addition to being unable to accept or even seriously entertain the necessary premises underlying the respondent's claim, were we to do so would mean the entire Pandora's box of past operations would require examination to consider all the concomitant expense and revenue items, in order to reach a conclusion as to what, if

any, earning deficiency may have suffered as a result of placing new plant in service from time to time. Even a momentary consideration of the magnitude of the effort involved to make such an examination of past operations, impresses upon us the wisdom of the regulatory principal [sic] that rate making is to be prospective in nature only, and that the quagmire of the past is to be ignored." Id., 54 Pa PUC at p. 407, 40 PUR4th at p. 107.

The respondent's claim here, claiming as it does a failure to earn the amount of depreciation expense booked for Shippingport, is a part of the quagmire of the past, and for this reason is the type of claim which we shall not entertain.

4. *CAPCO Cancellation Costs*

In the instant proceeding, as in its last two rate proceedings at R-80011069 and R-811470, Duquesne claimed a ten-year amortization of its investments in four canceled nuclear units: Davis Besse Unit Nos. 2 and 3 and Erie Unit Nos. 1 and 2. Duquesne's revised claim in this proceeding is for $3,469,739 per year for a ten-year period. In prior rate cases we deferred ruling on the cancellation charges issue, pending the outcome of the Central Area Power Coordination Group (CAPCO) investigation at I-79070315.

The respondent has noted that on October 25, 1982, Administrative Law Judge Joseph P. Matuschak issued his report of investigation at I-79070315. Then, relying upon the fact that ALJ Matuschak recommended, therein, that we permit Duquesne to amortize its portion of the cancellation costs of these plants, in appropriate rate cases over a period of ten years, with no return on the unamortized portion thereof, it argues that the

record in this proceeding, through its incorporation of the record in the proceedings at I-79070315, provides a basis for approval of its claim in this proceeding. Duquesne also notes that FERC has approved the ten-year amortization of these cancellation costs for accounting purposes, beginning with the recovery of such costs from the Duquesne's customers. Duquesne also calls to our attention that on December 31, 1980, it filed a petition with us, docketed at P-80120255, seeking permission to amortize for accounting purposes its $34 million investment, in accordance with the accounting treatment approved by FERC. Duquesne states that such costs must be charged to income in the year of disallowance, if the commission does not allow such costs to be recovered from ratepayers.

Duquesne's proposed adjustment was opposed by the staff, the OCA, and the commercial complainants. The staff argued that until the CAPCO investigation was completed we would be unable to make a fully informed decision as to the prudence of the original decision to build these nuclear units, and related issues. In addition, the OCA pointed out that it intended to file exceptions to ALJ Matuschak's recommended decision and the commercial complainants argued the merits of the adjustment, maintaining that no cost should be allowed. Pennsylvania Alliance for Jobs and Energy and the commercial complainants also oppose amortization.

The ALJ, first, noted that the commission at R-80011069 determined that any decision on the recoverability of these CAPCO cancellation costs should await the outcome of the pending investigation at I-7907315 ([1982] 50 PUR4th 272). Then, the ALJ stated that the conclusions reached by ALJ Matuschak are not final

and, therefore, concluded that it would be inappropriate to resolve the matter at that time.

The respondent filed an exception to ALJ's recommendation, arguing that to further delay an allowance for recovery of these dollars would be grossly unfair.

Events have overtaken much of what the parties have said by way of brief. The investigation at I—79070315 has been concluded. At public meeting of January 7, 1983 we adopted ALJ Matuschak's report of investigation dated October 15, 1982. Through our adoption of ALJ Matuschak's report of the investigation, we passed upon the merits of Duquesne's request to amortize their cancellation costs relating to Davis-Bessie Nos. 2 and 3 and Erie Nos. 1 and 2, in appropriate rate cases, in such amounts as therein determined, over a period of ten years, with no return on the unamortized balance thereof (exclusion from rate base).

The respondent's claimed investment in the cancelled units is $34,697,389 with a claimed ten-year amortization of $3,469,739. The dollar amount of the respondent's claim was not contested by any party. Accordingly, we shall approve the respondent's claim for $3,469,739 in this proceeding.

5. *Decommissioning and Spent Fuel*

At pp. 38 and 39 of the recommended decision the ALJ summarized Duquesne's expense claim for the decommissioning of Beaver Valley Unit No. 1 facility and the disposition of spent fuel as follows:

"Duquesne claims $245,615 as an expense item to provide for the decommissioning of Beaver Valley No. 1. This claim is consistent with the commission's earlier allowance in R-80011069. The methodology used in the

company's annuity calculation is identical to that previously accepted by the commission except that the tax-free interest rate used was updated to 9 per cent.

"The claim is uncontested and should be adopted.

"The company also claimed $2,667,000 for disposition of spent fuel from the Beaver Valley Unit No. 1 facility.

Duquesne's spent fuel claim in this proceeding is based on a program which has been developed by the federal government and approved heretofore by this commission. The essential elements of this program are summarized as follows:

"1. On site storage following discharge from the reactor.

"2. Prior to 1997, shipment of the fuel at utility expense to a federally operated interim storage facility (away from reactor) and the payment of $108 per kgu to the federal government to cover the cost of interim storage. The dollars associated with interim storage have previously been disallowed by this commission and without prejudice have not been claimed in this proceeding.

"3. Prepayment of a portion of the cost will be required prior to delivery for disposal.

"4. After 1997, shipment of spent fuel to a federally operated permanent storage depository.

"The Department of Energy estimates the costs for the ultimate disposal of spent nuclear fuel of $234 per kilogram of uranium. It is assumed that Beaver Valley will be shut down approximately annually for refueling and that about 52 spent fuel elements, having a total of 23,993 kilograms of uranium, will be discharged at the time of each refueling. The company's $2,667,000 claim

is based upon the $234 per kilogram cost times 223,993 kilograms times Duquesne's 47.5 per cent ownership.

"This claim is consistent with prior treatment of the issue and no party has contested its appropriateness. It should be adopted."

As noted above by the ALJ, the claims are uncontested and consistent with our prior decisions. Accordingly, we adopt the ALJ's recommendation and approve the respondent's claim.

6. *Edison Electric Institute and Electric Power Research Institute Dues*

Duquesne claims $315,000 for Edison Electric Institute (EEI) dues. Edison Electric Institute is an association of investor-owned electric utility companies. Duquesne's witness, Mr. Messner, described the benefits allegedly received by the ratepayers through the programs and activities of the institute, as follows:

"Helps electric companies generate and distribute electric energy at the lowest possible price, consistent with safe and reliable service;

"Advances the art of producing, transmitting, and distributing electricity including promoting scientific research to meet the need for electric power through environmentally acceptable means;

"Gathers and makes available factual information, data, and statistics of importance to customers and the industry;

"Serves the public and its government representatives by keeping them informed of all material matters relating to the generation and use of electricity in the United States, and speaks out effectively on the public

policy issues confronting the industry and electricity consumers."

The respondent's claim consists of $207,000 representing dues for regular activities and $108,000 which represents 1982 media communication dues. The claim for $207,000 relates to normal annual membership dues and has not been contested. Accordingly, we shall grant the claim of $207,000 representing dues for regular activities.

The OCA and the staff contest the expense claim representing the 1982 media communication dues. Both parties consider the programs to be lobbying efforts which do not directly benefit ratepayers.

The respondent contends that media communication dues represent expenditures for the purpose of informing the public regarding energy needs, energy sources, and the viability of the electric utilities, all to the ultimate benefit of ratepayers.

The ALJ considered the record to be replete with examples of EEI-sponsored media advertising dealing with such items as energy conservation. Although the ALJ did acknowledge that the benefit of some advertisements is less clear, he concluded that the record supports a finding that a substantial portion of this program is for media programs beneficial to ratepayers.

The staff and the OCA have filed exceptions arguing that the EEI's national media efforts are of a lobbying nature primarily aimed at increasing revenues.

While Duquesne claims ratepayer benefits, both the staff and the OCA have pointed out some specific instances where media communications programs did not, in our view, effectively benefit Duquesne ratepayers. On

balance, we are not satisfied that this expense results in direct benefits to Duquesne ratepayers. Therefore, we shall deny respondent's claim for $107,000 representing 1982 media communication dues.

The respondent has also claimed $2,887,000 for Electric Power Research Institute (EPRI) dues. Respondent states that for a number of years, a substantial amount of Duquesne's research and development (R & D) expenditures have been for the work of EPRI, which was founded in 1972 by the nation's electric utilities to develop and manage a nationwide co-operative industry research program for improving electric power production, transmission, distribution, and utilization. Respondent further states that the main purpose of EPRI is to develop improved technologies which can meet the changing needs of existing power systems and to foster the development of advanced alternatives for expanding those systems, while minimizing capital and operating costs, to the benefit of both the utility and the ratepayers. Respondent contends that the record in this proceeding contains numerous examples of ratepayer benefits from EPRI, both generally and specifically.

The ALJ's comments regarding the claimed benefits received by ratepayers through Duquesne's association with EPRI is set forth at pp. 42 and 43 of the recommended decision and is as follows:

"According to the company, these R & D findings have been transferred and utilized by Duquesne. Duquesne has representatives directly participating on various committees and receives extensive information through seminars and conferences sponsored by EPRI. Duquesne utilizes computer codes and data packages of EPRI with substantial cost savings. Duquesne depart-

ments, particularly the environmental affairs department, power stations department, nuclear department, and system planning, have benefited from EPRI technical reports with substantial savings in time and expense. Duquesne has utilized EPRI test facilities for significant savings. In particular, the Waltz Mill cable test facility produced a cable with reduced insulation thickness. This reduced wall cable saved Duquesne $500,000 on recent underground transmission projects and is expected to save more in the future. Additionally, Duquesne has utilized an EPRI program for nuclear safety relief valve testing which has resulted in an estimated savings of $1.5 million. There are other cost savings to the company that have also resulted from EPRI research projects contained in the record."

Duquesne's claim is opposed by the staff and the OCA. The staff first states that the claim ($2,887,000) represents 1983 expense levels for EPRI dues which creates a mismatch of revenues and expenses and therefore distorts the test year. Second, the staff argues the expense level claimed by Duquesne exceeds, by a substantial margin, the $885,634 EPRI expense level approved by the commission in R.I.D. 373. The staff proposed a reduction of $2,001,566 in the respondent's claimed operating expense to the $885,634 level previously allowed. Alternatively, the staff proposes a limit of a $1 million increase in the previously approved level of EPRI expenses, to reflect a more gradual movement toward the level of membership dues requested by EPRI.

The OCA would reduce the respondent's proposed test-year expenses by $1,623,000 to reflect "past commission policy."

The ALJ recommended rejection of the proposed adjustments to Duquesne's claimed operating expense for

EPRI dues and approval of the respondent's claim. The ALJ concluded that both the staff and the OCA had failed to rebut the extensive record evidence that payment of these dues are in the public interest or to justify limiting Duquesne's expense allowance to the 1974 level.

In Pennsylvania Pub. Utility Commission v Duquesne Light Co. (1981) 54 Pa PUC 695, 43 PUR4th 27, we reluctantly approved Duquesne's claim for EPRI dues of $885,634 which were actually paid in the test year. There, we relied primarily upon prior precedent in approving the claim, being of the opinion that Duquesne's showing that ratepayers benefited from the activities of EPRI was sorely deficient. In this proceeding, we find that the respondent has substantiated its claim that ratepayers do benefit from Duquesne's membership in EPRI. Therefore, we shall approve the respondent's entire claim in this proceeding.

7. *Emergency Energy Surcharge*

Duquesne seeks to include $1,101,116 in its test-year level of operating expenses, which represents unrecovered purchase power costs incurred as a result of the 1977-78 coal strike, not recovered through the then existing fuel clause.

Duquesne originally filed a petition at R-78010548 requesting permission to establish, for a limited period of time, an emergency energy surcharge of three mills per kilowatt-hour. By order entered March 2, 1978, at R-78010548, we granted Duquesne a surcharge of two mills per kilowatt-hour and limited collection of the surcharge to the period ending June 30, 1978. In response to Duquesne's petition for reconsideration, filed March 17, 1978, we entered an order on March 30, 1982,

which removed the time limitations for collecting the surcharge and directed that Duquesne file a plan for equal billing of the surcharge to all customers.

Duquesne filed monthly reports which indicated that $13,893,434 of excess purchased power costs were incurred and $11,691,202 was recovered from February, 1978, through August, 1978. Duquesne's claim reflects a two-year amortization of the unrecovered costs of $2,202,232 or $1,101,116.

The staff and the OCA oppose this claim. Both parties consider these 1977-78 unrecovered costs to be too remote to be appropriately included in future rates, based on a 1982 future test year. The staff notes that these expenses will not be incurred in 1982 or at any time in the future and if allowed would overstate operating expenses during the period rates are in effect.

Duquesne contends that this commission granted West Penn Power Company recovery of its emergency energy costs by order entered February 5, 1981, at R-80021082. Duquesne also asserts that the circumstances that existed in R-80021082 are substantially the same as in the present proceeding.

The ALJ first notes that since these costs were incurred there have been three successive rate applications filed by Duquesne where recovery could have been requested. The ALJ then recommended denial of the claim, concluding that these 1977-78 unrecovered costs were too remote in time to be included in future rates. Duquesne excepts to the ALJ's recommendation, reiterating the matters previously stated.

We approve the claim based upon, and consistent with, our action in Pennsylvania Pub. Utility Commis-

sion v West Penn Power Co. (1981) 54 Pa PUC 602, wherein we approved an expense allowance designed to recover similar costs over a two-year period.

8. *Net Negative Salvage*

Duquesne's income statement includes an amount representing the amortization of experienced net negative salvage during a five-year period. This amounts to $2,806,436. The manner in which the negative net salvage was calculated is consistent with Duquesne claims approved in prior proceedings. No evidence contesting this claim was submitted by the other parties and the ALJ recommended approval.

Duquesne's claim for net negative salvage is reasonable and is approved.

9. *Management Audit Expenses*

Duquesne increased its future test-year operations and maintenance expenses by $179,342 to reflect the annual amount of a three-year amortization of the management audit mandated by the commission. Duquesne asserts that the commission has historically allowed amortization of public utility commission (PUC) mandated management audit expenses.

The OCA opposed this claim arguing that this nonrecurring expense distorts the normal level of operating expenses for the test period. The staff proposes a five-year amortization period which reflects the period of time that the benefits of these extensive audits will be realized by the respondent in terms of better services.

The ALJ considered a three-year amortization period more reasonable and recommended approval of the respondent's claim. In making this recommendation, the ALJ noted the fact that the respondent's stockholders

have already borne one year's carrying costs for these expenses. The staff excepted to the ALJ's recommended approval of a three-year amortization period.

We adopt the ALJ's recommendation of a three-year amortization period as being more reasonable than the five-year period urged by the staff. The staff's exception is denied.

10. *EEOC Settlement Costs*

Duquesne claims $183,333 in annual operating expenses, which reflects a three-year amortization of Equal Employment Opportunity Commission (EEOC) settlement costs. Duquesne states that on September 4, 1975, the United States Department of Justice filed a complaint, in the United States district court for the western district of Pennsylvania, charging that Duquesne's assignment and preemployment selection criteria violated Executive Order No. 11246, and requested both injunctive relief and the payment of compensation to persons allegedly harmed as a consequence of Duquesne's wrongful conduct. On March 1, 1976, the complaint was amended to name the national and local unions representing Duquesne's employees as additional defendants.

On December 29, 1976, the federal Equal Employment Opportunity Commission filed suit, in the United States district court for the western district of Pennsylvania, against Duquesne and the national and local unions representing the Duquesne's employees, alleging that the company's employment practices, including assignment and preemployment selection criteria, violated Title VII of the Civil Rights Act of 1964, by discriminating against minorities and females. The complaint sought both injunctive relief and the payment of

compensation to persons allegedly harmed as the result of Duquesne's alleged wrongful conduct.

By order dated March 7, 1977, the court consolidated the two cases for trial purposes only. By order dated March 27, 1980, the court dismissed all claims against the company concerning acts or practices at its Warwick mine facilities. Duquesne, through its counsel, has submitted a consent decree to the government in an attempt to settle the cases.

Duquesne considers costs of litigation and settlement to be normal and ordinary costs of doing business and properly recoverable.

Both the staff and the OCA contest this claim. The staff considers the cost of defending allegations of unlawful management practices costs properly to be borne by stockholders. The OCA takes the position that the inclusion of these nonrecurring expenses, in the overall level of operating expenses, is inappropriate because it distorts the normal level of operating expenses for the test period.

After noting that Duquesne has not been found guilty of these charges, the ALJ acknowledged the fact that Duquesne will, if the consent decree is adopted, be required to pay $500,000 in damages to the complainants in the EEOC cases, by reason of alleged discriminatory hiring and employment practices. The ALJ then concluded that the ratepayers should not have to bear such expenses.

Duquesne excepted to the ALJ's recommendation and again urged that litigation costs are an ordinary cost of doing business and should be allowed as an ordinary expense.

Having considered the evidence and the contentions of the parties, we find that, while the expense claimed is one which is incurred in the business world from time to time, Duquesne has not satisfied its burden of proof that the claimed expense is a reasonable and necessary expense incurred to provide utility service. The claim is rejected and the respondent's exception is denied.

11. *Deferred One Oxford Centre Costs*

Duquesne seeks to increase operations and maintenance expenses by $38,841 to provide for the five-year amortization of deferred costs of $194,230, which represent engineering and consulting costs associated with the transfer of its corporate headquarters to One Oxford Centre. Duquesne asserts that these costs were incurred in order to ensure that the new offices would meet its needs. Duquesne's position is that amortization of such nonrecurring costs is in accordance with prior commission decisions.

Based upon the long-term nature of benefits derived from the engineering and consulting services, the staff argued that it would be more appropriate to amortize these costs over the life of the lease; i.e., twenty years.

The ALJ agreed with staff's position and reduced the respondent's claimed operating expenses by $29,129 to reflect a 20-year amortization. The ALJ, noting that customarily leasehold improvements are to be amortized over the life of the lease, analogized that associated services should be similarly amortized.

Duquesne has excepted to the ALJ's recommendation, pointing out that the analogy is improper in that leasehold improvements are assets which are includable in rate base, and that the instant costs will not be accorded rate base inclusion. Moreover, Duquesne argues, the

ALJ's adjustment is inconsistent with the fact that these expenses are the types of costs which will recur with the subsequent occupancy of new power stations, office buildings, and other facilities. Finally, Duquesne argues, these costs are no different than other implementation costs such as installation of computer equipment which, it states, the commission has traditionally amortized over five years rather than capitalized and depreciated over the equipment's life.

We note that no party took issue with the allowance of this claim, even though it represents an expansion of the types of expenses historically granted amortization treatment by this commission. As opposed to merely litigating the question of an appropriate amortization period, which is basically a judgmental decision, we would rather have seen the parties address the threshold question, which is whether this nonrecurring expense is one which should be accorded amortization treatment.

While we are not necessarily persuaded by the ALJ's rationale for adjusting the respondent's claimed operating expense to reflect a 20-year amortization of these deferred costs, we shall adopt his recommendation, without expressing any final conclusion, at this time, on the basic question as to whether amortization treatment is appropriate.

12. *Residential Conservation Service*

Duquesne increased test-year operations and maintenance expenses by $115,400 to reflect that portion of the expenses of the residential conservation service program (RCS), not directly recovered from rate-payers, in accordance with our order at 1-80010329. No evidence contesting this adjustment was submitted by any party, and the ALJ recommended that we approve the adjustment.

We find Duquesne's claim for RCS expenses reasonable, and it is approved.

13. *Maintenance Expenses—Account 513*

Duquesne states that it incurred $6,782,000 in Account 513 (prime movers, generators, and accessory electric equipment) expenses in 1981, and budgeted $6,746,000 for 1982.

The staff states that the respondent's experienced 1981 expenses in this account were $2.6 million over the 1980 maintenance expenses and the respondent has continued this same level of expenses in its 1983 budget. The staff witness, Mr. Jones, contends that an analysis of the reasons for this increase in 1981 maintenance expenses, reveals that approximately $2 million of the $2.6 million increase can be accounted for by the major maintenance work which was performed at the Cheswick plant in 1981. He concludes that the Cheswick plant maintenance expense was of a nonrecurring nature and asserts that the respondent has ignored the nonrecurring nature of this expense in developing its 1982 projections. The staff, therefore, recommends that the amount budgeted for Account 513 maintenance expenses for 1982 be reduced by $1,570,191 based upon five-year amortization of the major inspection and overhaul at Cheswick.

Duquesne argues that by simply looking at one plant or one account the staff fails to consider the entire system and the ongoing level of such expenditures. Duquesne emphasizes that it is the overall level of maintenance expense which should be considered for rate-making purposes. Finally, Duquesne states, that the actual 1982 expenses through August were slightly above budget.

The ALJ rejected staff's proposed adjustment. The ALJ agreed with the respondent that it is the overall level of maintenance expense which is significant, since the level at each individual plant may vary from year to year. The ALJ also appears to have been impressed by the apparent fact that 1982 actual expenses are running slightly higher than budgeted.

The staff has excepted to the ALJ's recommendation, arguing that following the ALJ's approach of considering the respondent's entire maintenance program would effectively limit the commission's ability to examine the reasonableness of Duquesne's future test-year claims.

In view of the fact that 1982 actual expenses are running slightly higher than budgeted, the respondent's claim appears to be reasonable and it is approved.

14. *Maintenance Expenses—Account 552*

The staff proposed a similar adjustment to Account 552 (maintenance of structures—other power generation). The staff contends that the data provided by the company, reveals that the substantial increase in the 1982 budgeted amount for Account 552 maintenance expenses, was due primarily to the $300,000 painting project, performed eight years ago, at the Brunot Island plant. Accordingly, the staff witness, Mr. Jones, recommended that the 1982 budgeted amount for Account 552 maintenance expenses, be reduced by $262,500 to reflect an amortization of these nonrecurring maintenance expenses (Brunot Island painting) over eight years.

Duquesne again argues that the staff has singled out expenses incurred at one station, without considering the overall level of expenses. According to the respon-

dent, Account 511 (maintenance of structures—steam power generation) and Account 552 are interrelated for budgetary purposes. While Account 552 has increased $270,000, Duquesne states that Account 511 for the remainder of the facilities has decreased by $152,000 which results in a net total increase of about $118,000, or less than five per cent over 1981 costs, without any consideration for inflation. Moreover, the respondent notes, these accounts (511 and 552) cover all facilities maintenance at coal- or oil-fired stations such as roof repairs, road and grounds maintenance, and services such as water and sewage.

The ALJ found the respondent's position to be meritorious and recommended approval of the claim. The staff excepts to the ALJ's recommendation, arguing that the above mentioned adjustment should be made to reflect the nonrecurring nature of this expense.

For the reasons stated previously, we shall again adopt the ALJ's recommendation that the respondent's expense claim be approved.

15. Legal Expenses

Staff proposed an adjustment to the respondent's estimated claim for 1982 legal expenses of $1,595,000. Both the staff and the OCA consider the claim to be excessive. The relevant data is as follows:

ACCOUNT 923.101 LEGAL SERVICES

1979	$ 850,169	—
1980	902,417	+ 6.1%
1981	1,323,683	+46.7%
1982 (est)	1,595,000	+20.5%

Staff emphasizes that the respondent's budget projects 1982 legal expenses to increase by an additional 20.5 per cent beyond the level already incurred in 1981.

The staff argues two points in support of its position that the expenses are overstated or excessive. First, the 46.7 per cent increase in 1981 is unusually large and should be considered an aberration in the trend of mounting legal expenses. Second, actual legal expenses for the first six months of 1982 were $521,276—for a 1982 annualized level of $1,042,552. Since the 1982 annualized level, based on actual expenses, is substantially less than the budget estimate for the year, the staff concludes that the respondent's 1981 legal expenses were unusually high and not reflective of a normal level.

The staff proposes that the 1982 legal expenses be normalized to reflect the 1980-82 three-year average of $1,273,833 in lieu of the $1,595,000 claimed by the respondent. This would result in a reduction of $321,167 in the respondent's claim.

The OCA proposed that the respondent's claim for legal expenses be reduced by $181,000 to reflect actual experience for the first six months of 1982, which is lower than estimated.

Duquesne contests the staff's proposed adjustment, arguing that as of September 30, 1982, the actually incurred "other operation expenses" (including legal) were above budget, while net operating income was below budget. Duquesne, first notes that the staff has not proposed an adjustment to pick up these deficiencies, then concludes that the staff's unsubstantiated adjustment is improper and should be rejected.

The respondent's data indicating that total operating expenses were exceeding budgeted amounts was given little weight by the ALJ. The ALJ adopted the staff's adjustment. The ALJ viewed the three-year average as a better basis for estimating this expense, which, in

turn, is supported by respondent's experienced legal expense level for the first half of 1982.

Duquesne excepted to the ALJ's recommended adoption of the staff's adjustment. Duquesne argues that the adjustment is improper since there has been no challenge to the reasonableness of any item, and no consideration given to the intervening inflation between 1980 and 1982 or the additional legal services required. According to Duquesne, the ALJ misunderstood the evidence and its contention. Duquesne argues that it did not make a comparison on the basis of "company-wide" actual total operating expense but rather based its comparison on expense "other" (including legal).

We agree with the ALJ's recommendation that the staff's adjustment be adopted. The normalization of 1982 legal expenses, proposed by staff, reflects a reasonable level of expense for the test year. As noted by the ALJ, the 1982 annualized level, based on actual expenses for the first six months of 1982, is substantially less than the budget projection for the year. It appears that respondent has overbudgeted 1982 legal expenses. Respondent's exception is denied.

16. Amortization of Beaver Valley No. 1 Ice Damage Expenses.

Duquesne has made an upward adjustment of $127,559 which is designed to recover, over a three-year period, the costs of repairing the Beaver Valley No. 1 cooling towers, which sustained ice damage during the winters of 1976-77 and 1977-78.

The staff and the OCA object to the adjustment proposed by Duquesne. It is the staff's view that the ice damage sustained by the Beaver Valley No. 1 cooling tower resulted from the inherently faulty design of the

structure. The staff states that Duquesne reached a settlement with the engineers and architects responsible for the poor design and recovered all but approximately $383,000 of the $1.7 million damage sustained. It is the staff's position then that, in effect, Duquesne is proposing that the ratepayers become the insurers of last resort through this proposed adjustment. The staff argues that ratepayers already insulate the respondent from property damage expenses through payment of insurance premiums and legal fees and that if these measures do not fully insulate the respondent from its casualty losses, then the staff is of the opinion that the risk should then be borne by stockholders.

The OCA has taken the position that the claim could have been filed earlier and should be rejected for untimeliness.

Duquesne states that ice damage to cooling towers is not an uncommon event, because moisture laden vapor rising up the tower condenses, and in cold weather may form a substantial buildup of ice, causing damage. Duquesne asserts that the unrecovered costs ($383,000) are akin to the deductible coverage generally provided in insurance policies. Citing Pennsylvania Pub. Utility Commission v Pennsylvania Gas & Water Co. (1981) 55 Pa PUC —, as authority for its adjustment, Duquesne states that its staff's position should be rejected.

The ALJ was in agreement with the arguments proffered by the staff and recommended rejection of the proposed adjustment. The ALJ also considered the question of remoteness in rejecting the respondent's claim. Duquesne excepted to the ALJ's recommended rejection of the proposed adjustment, arguing again that

there is no evidence that the damage occurred as a result of design imperfections.

The PG & W case cited dealt with cold weather storm damage amortization, which has been customarily permitted. Duquesne's initial capitalization of the damage expense belies its position that the damage in question is of the nature for which we have historically permitted amortization. The damage in question was suffered approximately five years ago. Further, it is remote in time. In this instance, had this expense been initially amortized, it would have been recovered in rates or absorbed by the company some time ago. We shall not entertain it at this time. The adjustment is rejected and Duquesne's exception is denied.

17. *Other Advertising Expenses*

Duquesne has claimed some $860,000 for advertising expenses.

The OCA witness, Mr. Henkes, proposed that $162,000 of "other advertising expenses" be eliminated. The OCA does not dispute that the majority of the advertising expense claim relates to health and safety, conservation, rates and billing practices, and education. That amount the OCA does, at least tacitly acknowledge as reasonable and appropriate, saying that the balance of this expense claim consisting of $162,000 is that which Duquesne has incurred through its support of Edison Electric Institute's special post-Three Mile Island communication activities. The OCA argues that there is no public benefit from such advertising.

Duquesne contends that such advertising is pursued in order to better inform the public of issues related to the growing national concern of the safety of nuclear power generation.

The ALJ recommended allowance of the claim, concluding that the expense was of a minor nature and does serve the public interest. The OCA has excepted to the ALJ's recommendation. In the opinion of the OCA, forcing ratepayers to fund this campaign is unconstitutional and inequitable, regardless of the cost.

While we do not necessarily agree with OCA's position we fail to see how this expense is of benefit to Duquesne's ratepayers. Accordingly, the OCA's exception is granted and the claim is denied.

18. *Interest on Customer Deposits*

Consistent with our adoption of the ALJ's recommendation that customer deposits be deducted from rate base, we are increasing the test-year level of operating expenses by $153,000 to reflect the 9 per cent interest paid to customers on customer deposits.

B. *Depreciation Expense*

Duquesne's annual depreciation expense claim for Pennsylvania jurisdictional operations is $66,706,000. No party has taken issue with this claim. We find the claim reasonable and it is accordingly approved.

C. *Taxes*

1. *Amortization of Deferred Federal Income Tax*

A large portion of Duquesne's deferred federal income tax reserve was collected from ratepayers at a 48 per cent rate, existing at the time of the individual rate proceedings, until January 1, 1979. On January 1, 1979, the marginal tax rate was reduced to 46 per cent, the current marginal tax rate. As Duquesne had previously accrued amounts at the 48 per cent rate, the reserve for deferred taxes is overaccrued. The OCA

proposes that the excess 2 per cent or $2,149,200 be amortized to income over a three-year period.

After acknowledging that the commission has flowed back this excess in other proceedings, Duquesne contends that the evidence of record in this proceeding indicates the inappropriateness of any adjustment. The respondent's witness, Mr. Ellenberger, stated that "[w]hen the accumulated deferred balances are amortized back to income, they are done so by applying the tax rate in effect when the deferrals were created." Mr. Ellenberger considers this treatment to be sound because, allegedly, it is in accord with generally accepted accounting principles and regulatory pronouncements. Additionally, the respondent states that other commissions have refused to make any adjustment for the change in the federal income tax rate.

The ALJ concluded that there was no dispute that the excess be returned to the ratepayers, but, rather, the question being the amortization period. The respondent's position is that the excess should be amortized over the remaining tax life of the property, some twenty to thirty years. The ALJ found Duquesne's method for returning the amount unacceptable, since ratepayers would not receive any benefits until well into the future, citing Pennsylvania Pub. Utility Commission v Philadelphia Electric Co. (1980) 54 Pa PUC 1, 33 PUR4th 319, for this conclusion. Thus, following what he believed to be past commission practice, the ALJ ordered a five-year amortization period.

Duquesne and the OCA have both filed exceptions to the ALJ's disposition of the deferred tax amortization issue.

Although Duquesne admits that its normal procedure would be to flow back the deferrals over the life of the property, it argues that a significant portion of these deferrals were not contributed by ratepayers. The respondent contends that of the $2,149,000, a total of $900,000 were not ratepayer funds. Further, Duquesne contends that the ratepayer has received the full benefit of a rate base reduction of that amount.

In its exceptions, the OCA notes that the cases relied on by the ALJ in using the five-year payback period were decisions made in early May of 1979 (Pennsylvania Pub. Utility Commission v Philadelphia Electric Co. [1980] 54 Pa PUC 1, 33 PUR4th 319 and Pennsylvania Pub. Utility Commission v Philadelphia Electric Co. [1980] 37 PUR4th 381, 54 Pa PUC 220), nearly four and three years, respectively, from the time a decision will be reached in this proceeding. The OCA argues that a three-year period is more consistent with the early decisions to use five-year period, because of the passage of time since those early decisions.

Having considered the contention of the parties, we conclude that a three-year amortization period is appropriate, particularly in light of the relatively modest amount involved. Consistent with this conclusion the OCA's exception is granted and that of Duquesne is denied.

2. *Normalization of State Taxes*

Duquesne is proposing the normalization of state income tax reductions attributable to (a) accelerated cost recovery system (ACRS) of the Economic Recovery Tax Act of 1981,[8] (b) liberalized depreciation based upon

[8]The respondent has petitioned to remove this item from this proceeding and have it considered at R-822173. The respondent's petition,

(Footnote continued on following page)

preasset depreciation range system (ADR) lives for capacity-increasing property acquired after 1970, and before 1981, and (c) liberalized depreciation based upon ADR lives for capacity-increasing property acquired after 1970 and before 1981. Duquesne argues that normalization of income tax benefits arising from liberalized depreciation, ADR, ACRS, and the job development and investment tax credits is required by federal law or established by commission precedent, and essential to the equitable distribution of those tax benefits to the customers.

The OCA takes the position that the commission should not impose the burden of normalization of state income tax reductions upon ratepayers for the purpose of improving the respondent's cash flow. While the OCA acknowledges that our past "flow-through" policy has been altered in the recent Pennsylvania Power Company case at R-811510, January 22, 1982, and the recent Philadelphia Electric Company case at R-811626, May 21, 1982, the OCA argues that due to the severe economic conditions in the respondent's service territory the imposition of this "noncost" upon ratepayers is unreasonable. The OCA also contends that while federal income taxes may be required to be normalized, state taxes are not. The ALJ, citing commission precedent on this issue, recommended that state income taxes be normalized. The OCA has excepted for the reasons previously stated.

(Footnote continued from previous page)

filed on September 30, 1982, at R-822173, requested that the commission, in an order entered before January 1, 1983, authorize the normalization required by the Economic Recovery Tax Act of 1981, in order that Duquesne will be able to avail itself of the accelerated cost recovery system (ACRS) benefits for post-1980 property. This subject is addressed below.

We adopt the ALJ's recommendation. The ALJ's recommendation is entirely consistent with our past disposition of such claims. See Pennsylvania Power Co., R-811510, Jan. 22, 1982; Philadelphia Electric Co., R-811626, May 21, 1982; Philadelphia Electric Co. R-811719, June 25, 1982; Pennsylvania Pub. Utility Commission v Bell Teleph. Co. of Pennsylvania, R-811819, Sept. 3, 1982; Pennsylvania Pub. Utility Commission v UGI Corp. R-821899, Dec. 17, 1982. Specifically, in the Pennsylvania Power case we granted the company's request to normalize state income taxes and relied upon the following rationale for our decision:

"We conclude that it is in the public interest that this request should be granted in its entirety. We do not believe that the company's current customers will be unduly burdened by this finding, and, more importantly, we believe such action is most fair to future customers. In addition, the allowance of the company's claim should improve its financial position with attendant benefits, not only to its investors, but to its customers as well." Id. at 27.

The OCA's arguments for flow-through treatment of state income taxes have not persuaded us to depart from our stated policy of normalization. Accordingly, the exception filed by the OCA is denied.

3. *Accelerated Cost Recovery System Issues*

On September 30, 1982, we received a petition by Duquesne to remove the issue of the appropriate treatment of the tax benefits associated with the accelerated cost recovery system (ACRS) from this rate proceeding (at R-821945). Duquesne also sought permission to put into effect the rates contained in Supplement No. 58 to Tariff Electric-Pa PUC No. 14 which provided for a

$15,475,000 annual revenue increase to reflect the normalization of the ACRS tax benefits under the Economic Recovery Tax Act of 1981, for the future test year ending December 31, 1982, and the normalization of the Pennsylvania corporate net income tax. By suspension and investigative order issued on November 5, 1982, at R-822173, we suspended the operation of Supplement No. 58 until a final order as to its reasonableness could be issued, which in no event would be later than December 31, 1982. On that same day, a hearing on the petition and supplement was held in Harrisburg before Administrative Law Judge (ALJ) Joseph J. Klovekorn where the respondent, the staff, and the OCA all participated.[9]

The staff took the position that Duquesne had overstated the minimum rate increase required to qualify it for ACRS depreciation with respect to post-1980 property additions. There (at R-822173), the staff urged the disallowance of that portion of the increase sought relating to 1982 property additions and that portion of the proposed increase based upon normalization of the state income tax benefits of ACRS depreciation with respect to 1981 and 1982 property additions. This would reduce the revenue increase proposed there to $5,842,023.

On December 1, 1982, ALJ Klovekorn issued a recommended decision which recommended granting Duquesne's petition for normalization, pursuant to § 168(c) of the Internal Revenue Code, of federal tax expense, with respect to depreciation deductions on post-1980 property additions, and further recommended that Duquesne be permitted to file a revised tariff

[9]The Pennsylvania Alliance for Jobs and Energy (PAJE), filed a response to Duquesne's petition, but did not participate.

supplement designed to produce $15,482,286 in additional annual revenues. Exceptions to the recommended decision were filed by Duquesne, the staff, the OCA, and Senator Leonard J. Bodak.

By opinion and order, issued December 17, 1982, we concluded that Duquesne demonstrated a need for additional annual revenues amounting to $5,842,023, and that the rate increase should be spread uniformly to all customer classes with no change in the existing customer charges. In arriving at this conclusion, we adopted the staff's recommendation that that portion of the requested income relating to 1982 property additions and that portion relating to the normalization of state income tax benefits, of ACRS depreciation, with respect to 1981 and 1982 property additions be denied at that time.

Pursuant to our December 17, 1982, opinion and order, Duquesne filed Supplement No. 61 to become effective December 18, 1982. In its reply exceptions, herein, Duquesne states that although these dollars ($5,842,023) are included in the Tariff No. 15 filed in this proceeding, the total revenue increase to be allowed must reflect the ACRS revenue requirement for both 1981 and 1982 additions, not just the 1982 additions. Duquesne stated it another way by asserting that the $5,842,023 should not be deducted from the amount of rate relief to be allowed in this proceeding, so long as revenue requirements shortfall at existing rates is based upon Supplement No. 52 levels.

In this proceeding, Duquesne has included in its claim, full normalization of both federal and state income taxes, relating to the application of ACRS depreciation rates over the depreciation expense resulting

from the asset lives used for rate making and the straight-line method used for rate-making depreciation, for all post-1980 property additions. We agree with Duquesne that since its entire showing in this proceeding is based upon Supplement No. 52 rates, no adjustment need be made here for the additional revenues allowed in Supplement No. 61, because those rates will be superseded by our allowance herein. Stated in another manner, our allowance herein will be cumulative, rather than an incremental allowance over Supplement No. 61 rates.

4. *Interest Adjustments*

The respondent states that interest charges must be allocated between utility and nonutility operations,[10] as required by Federal Power Commission Order No. 389, dated October 9, 1969, and as allowed by the commission in previous proceedings. For purposes of this allocation, the respondent has classified construction work in progress (CWIP) as "nonutility plant," consistent with its exclusion of these amounts from rate base. By reason of the $595,810,465 of construction work in progress, respondent allocated $43,705,671 in interest expense to nonutility operations. This amount was derived by utilizing the most recent debt interest rates which, it says, have in fact been used to finance CWIP.

The OCA contests the propriety of, and methodology employed by, Duquense. The OCA position is that the higher cost rates assigned by Duquesne CWIP is included in Duquesne's overall rate of return and consistent with paying a rate of return at this higher overall rate, ratepayers should enjoy the tax benefits associated with these higher interest costs. However, argues the OCA, the respondent's methodology has not accorded

[10]This results in an adjustment increasing state and federal income taxes.

ratepayers the benefit of the income tax deductions which accompany these high-interest costs.

Mr. Henkes, the OCA witness on this issue, recommends that a pro forma interest expense be used for purposes of computing test-year income taxes, and that it be set at $85,596,000, which is $15,609,000 higher than the $69,987,000 proposed by Duquesne. This reduces state and federal income taxes by $7,756,000.

With regard to this proposal, the respondent states that the CWIP which was financed by these new debt issues has not been included in rate base. Consequently, says the respondent, if the ratepayer does not pay a return on this capital and at the same time receives the benefit of an income tax reduction for the interest associated interest expense, he is receiving a double benefit.

The respondent has excepted with regard to the fact that the ALJ's calculation, found in his Table VI, does not conform to the conclusion reached in the text of the recommended decision.

The respondent's argument obfuscates the issue. The issue is not whether ratepayers should receive the income tax benefit of the interest expense related to CWIP, but, rather, whether the most recent and highest interest rates should be assigned to CWIP, while at the same time, by reason of its inclusion in the calculation of the embedded cost of debt, and thereby the allowed rate of return, ratepayers are obliged, at least in part, to pay the interest expense. To be consistent, if the respondent wishes to exclude the interest expense associated with the approximately $600 million of CWIP not included in rate base, then some $600 million of the highest cost debt should be excluded from the calculation of the embedded cost of debt, in order that ratepayers not be obliged to pay any of the interest expense associated

therewith. Stated another way, the inclusion of all of the higher debt cost in the embedded cost of debt calculation, obliges ratepayers to pay more by way of interest expense than is in fact experienced in relation to the adopted rate base.

For these reasons, we conclude that a pro forma interest expense calculation and income tax adjustment is required. The respondent's exception is denied.

There is another issue involved in the subject of interest expense for the purposes of the income tax calculation, which was not pointedly developed by the OCA witness. Respondent's estimated test-year interest expense is not annualized to the test-year-end level. Our customary calculation of a pro forma interest expense is prompted by the need to state it on the same basis as the test-year-end (or beyond) embedded cost of debt calculation[11] and the year-end rate base. Almost universally the product of the embedded cost of debt and the adopted rate base will exceed test-year interest expense. To the extent that ratepayers are obliged to provide this higher interest expense by way of income available for return, it is only appropriate that they enjoy the cost-reducing effect thereof, by way of a reduced income tax expense.

This subject provides yet another reason why a pro forma interest expense calculation is required. However, since we have adopted a slightly different cost of debt and rate base than proposed by the OCA, we must perform our own pro forma interest expense calculation and income tax adjustment.

The OCA has taken issue in another respect with Duquesne's interest expense and consequently its in-

[11]Not infrequently the embedded cost of debt which is adopted, includes consideration of a prospective-debt issue beyond test year-end.

come tax calculation. It states that Duquesne has excluded from it interest expense, that expense associated with that portion of rate base the funds for which are derived from unamortized job development tax credit (JDIC).[12] The essence of the OCA's position is that since ratepayers are required to provide a rate of return on that portion of plant funded by JDIC, to the extent that a portion of that rate of return represents hypothetical interest expense it should be offset, in part, by a hypothetical tax savings resulting from the tax deductibility of interest expense. The respondent's position is that the OCA's position is in error and was specifically rejected by the North Carolina Utilities Commission in Re Southern Bell Teleph. & Teleg. Co. (1982) 46 PUR4th 285.

The AJL found the North Carolina commission's reasoning persuasive.[13] The OCA has excepted and cites the decision of the U. S. court of appeals for the District of Columbia in NEPCO Municipal Rate Committee v Federal Energy Regulatory Commission (1981)—US App DC—, 668 F2d 1327, as approving an interest and tax expense treatment consistent with that which it advocates here. The OCA also cites our opinion and order in Pennsylvania Pub. Utility Commission v Pennsylvania Power & Light Co. (1981) 54 Pa PUC 645, as according similar treatment to investment tax credits. There we said:

"In calculating our dollar return, rate base times the rate of return, if the unamortized investment tax credit

[12]The OCA's pro forma interest expense calculation, based as it is on total rate base, includes interest expense associated with funds derived from unamortized JDIC and is, therefore, in conflict with his text.

[13]Although agreeing in principle with the respondent, the ALJ's calculation in Table VI of the recommended decision is based upon his total recommended rate base and therefore conflicts with his text.

is included in rate base, as required by federal law, the ratepayer would provide a return on those funds supplied by the government. To be consistent, the ratepayers should receive any benefit arising out of the inclusion of these funds in rate base. This benefit is provided by the deduction of the interest expense normally generated by debt for income tax purposes.

"Further, it is assumed that these government-supplied funds are a surrogate for debt, preferred, and equity capital which normally could be raised by outside financing. By applying a rate of return to these funds, we are treating them as if this capital was supplied in identical proportions to that supplied by the investor. Having applied the rate of return to these funds, were we to fail to accord them the same tax status as investor supplied, we would be creating an addition [sic] pool of dollars available for return to investors, effectively increasing the return on common equity.

"Under PP&L's (Pennsylvania Power and Light Company) proposal, ratepayers are being charged once for the tax expense, and a second time for a return on property paid for by the tax expense dollars, and would not be provided the benefit of the associated tax deduction for interest computation purposes. We find that the adjustment proposed by the OCA and trial staff reflect this benefit. We grant trial staff's and OCA's exceptions."

The reasoning set forth there is equally applicable here. The only question remaining then is whether this treatment is precluded by the Internal Revenue Code and/or Treasury regulations. We have closely examined

§ 46 of the Internal Revenue Code and § 1.46-6 of the U. S. Treasury regulations and based upon our analysis neither the code nor Treasury regulations require the exclusion of consideration of the applicable hypothetical interest expense in determining federal income tax expense for rate-making purposes. To paraphrase the thoughts expressed above in quotation from our opinion and order in the Pennsylvania Power and Light Company case, we have consistently chosen to accord those portions of rate base funded by investment tax credits and job development tax credits, an overall rate of return rather than an equity return. In doing so we have recognized that when translated into dollars in the form of income available for return, and hence to an operating revenue requirement, the overall rate of return produces a different (lower) operating revenue requirement than does equity at the same stated percentage rate, because of the difference in deductibility for tax purposes. Looking at the matter from a different perspective, although the income available for return provided on this portion of rate base, at an overall rate of return level, is an amalgam of hypothetical interest, preferred dividends, and equity return, Duquesne, for the purposes of income tax expense, is treating the income available for return as if it were entirely a hypothetical equity return. The result would be to force upon ratepayers a higher effective cost at the operating revenue level, which is what they in fact pay, than the stated return rate would normally indicate.

We find that many of these same thoughts were expressed by the court, or by the Federal Energy Regulatory Commission and viewed with favor by the court, in the NEPCO case. We quote at some length from that opinion:

"(3) *Calculation of NEP's Interest Deduction*

"In determining a utility's federal income tax expense (as an element of cost of service) for rate-making purposes, FERC must determine NEP's interest expense, a deductible item. To the extent that interest expense decreases, tax expense increases, and customer rates must be increased to pay the tax expense.

"In its December 31, 1979, order in W-2, FERC determined that NEP's interest deduction should be determined without regard to the tax credit. NEP argues that because FERC has already decreased cost of service by a ratable portion of the tax credit funds, the inclusion of those funds in the calculation of the interest deduction further reduces cost of service, producing in turn, says NEP, an overall return lower than the minimum mandated by the code and IRS regulations.

"The question in this section is whether FERC may properly treat tax credit funds in relation to interest deduction in the same way it treats tax credit funds in relation to rate of return determination. Federal Energy Regulatory Commission assumes that the company would, absent the credit, have acquired financing by using a combination of debt and equity in the same proportion they bear in present capitalization (less tax credit funds). That assumption creates an 'alternative utility' that might have evolved in the absence of tax credit funds. The capital structure so created is speculative but permissable, in view of the impossibility of determining exactly what financing, and consequent interest payment, the utility might have arranged absent the investment tax credit. As FERC noted:

"'The only administratively feasible approach is to assume that nothing except the source of cash would

have changed if the credits had not been available. The commission has thus determined that, for rate-making purposes, it will be assumed that in the absence of investment tax credits a utility would have financed the ADITC portion of its rate base with the same proportions of debt and equity, reflected in its capital structure by which it has financed the remainder of its rate base.'

"NEP and FERC offer contrasting and complex economic scenarios and relate them and their alleged results to § 46(1)(2)(A). As this court indicated in New Mexico, *supra*, however, our role does not entail economic speculation:

"'As a matter of economic theory, the competing theories advanced by FERC and PNM raise questions that are undoubtedly complex. The question before this court, however, is not. The function of this court is not to speculate on the manner in which a utility would finance investment in a world devoid of the investment tax credit. Since no issue of statutory interpretation is presented, the question before this court is simply whether the factual assumption relied on by the commission in applying the statute is arbitrary, capricious, or an abuse of discretion. We hold that it is not.' Id., 668 F2d at p. 689.

"This court went on to discuss application of the arbitrary/capricious standard to the issue presented here:

"'As discussed above, we believe that the commission's assumption of capital acquisition in the absence of the credit is not arbitrary, capricious, or an abuse of discretion. As a result, we affirm the commission's decision to exclude ADITC from capitalization. Assuming

that the capital otherwise provided by the credit would be supplied by debt as well as equity, the exclusion of ADITC from capitalization does not significantly affect the debt ratio. Consumers bear the same cost of service, excluding the ratable reduction permitted by the statute, as they would pay in the absence of the credit. No violation of § 46(f)(2) exists.' Id., 668 F2d at p. 691.

"Accordingly, we find no reversible error in FERC's approach to calculation of NEP's interest deduction. [Footnotes omitted]" Id., 668 F2d at pp. 1337, 1338.

We conclude that the court has specifically approved the calculation of interest expense as proposed here by the OCA and the method which we adopted in our opinion and order in the Pennsylvania Power and Light case. We shall adopt as interest expense for the purposes of income tax expense, the product of our adopted fair value rate base and the weighted cost of debt. Accordingly, the OCA's exception is granted and that of Duquesne denied.

In its exceptions Duquesne also states, with regard to the ALJ's interest calculation, that: "The calculation assumes that cash working capital is financed in part by debt. Both the consumer advocate witnesses admitted that cash working capital is financed by equity." Duquesne provides no record citations for the latter sentence, nor does it argue the correctness of this position. However, regardless of the view or position of the witnesses, it has never been our position, nor to our knowledge has this commission ever taken the position, that cash working capital is funded in its entirety by common equity. If we were to accept Duquesne's position, then the capital structure to be applied to a rate base excluding cash working capital must of necessity be modified to increase the debt and preferred stock

component and decrease the equity component. We conclude that if the capital structure is modified to reflect the 100 per cent equity cash working capital, the product of this alternative calculation, which is interest expense, will be the same. The respondent's position is rejected and its exception denied.

As stated above we shall calculate pro forma interest in the traditional manner.

5. *Taxes Other than Income*

We believe that the ALJ's recitation at p. 55 of the recommended decision adequately summarizes respondent's claim for taxes, other than income taxes. The ALJ's recitation is as follows:

"Duquesne's taxes, other than income taxes, for the estimated twelve months ended December 31, 1982, amount to $62,424,000. For rate-making purposes, the amount of FICA tax expense was adjusted by $711,081 and $539,138 to reflect an annualization of the January 1, 1981, increase in the employee's Social Security base from $29,700 to $32,400 as well as the increased rate from 6.65 per cent to 6.67 per cent. The company also adjusted the budget amount for the PUC general assessment to reflect the commission's and consumer advocate's latest assessments. Duquesne adjusted its Pennsylvania public utility realty, capital stock taxes, and Ohio property taxes applicable to the company's interest in Ohio plant and inventory to reflect current rates and values. The company's Pennsylvania capital stock tax, public utility realty tax, and the gross receipts tax expenses were eliminated to the extent that such expenses are recaptured through the state tax adjustment surcharge and net energy clause. Duquesne's tax expenses were increased [to] relfect [sic] an increase

in the gross receipts tax on the additional revenues due to the application of Tariff No. 15 rates for a full twelve months."

After noting that evidence contesting these claims was not submitted by any party, the ALJ recommended approval of the respondent's claim. We find the claim reasonable and shall adopt the ALJ's recommendation, except to the extent that the claim is dependent upon and will be affected by the operating revenue allowance permitted herein.

V. *Rate of Return*

Duquesne, as a public utility, is entitled to an opportunity to earn a fair rate of return on the fair value of its property. Pennsylvania Gas & Water Co. v Pennsylvania Pub. Utility Commission (1975) 19 Pa Cmwlth 214, 11 PUR4th 38, 341 A2d 239; Keystone Water Co. v Pennsylvania Pub. Utility Commission (1975) 19 Pa Cmwlth 293, 302, 330 A2d 873, 877; Riverton Consolidated Water Co. v Pennsylvania Pub. Utility Commission (1958) 186 Pa Super Ct 1, 24 PUR3d 9, 140 A2d 114. Rate of return can be defined as:

". . . the amount of money a utility earns, over and above operating expenses, depreciation expense, and taxes, expressed as a percentage of the legally established net valuation of utility property, the rate base. Included in the 'return' are interest on long-term debt, dividends on preferred stock, and earnings on common equity. In other words, the return is the money earned from operations which is available for distribution among various classes of contributors of money capital." *"Public Utility Economics,"* Paul J. Garfield and Wallace F. Lovejoy (1964), at p. 116.

The return authorized must not be confiscatory, and must be based upon the evidence presented. City of Pittsburgh v Pennsylvania Pub. Utility Commission (1949) 165 Pa Super Ct 519, 82 PUR NS 572, 69 A2d 844.

Although it is acknowledged that the fair rate of return and cost of capital are not always synonymous, we consider the cost of capital to be one of the important bases upon which a fair rate of return is determined. Lower Paxton Township v Pennsylvania Pub. Utility Commission (1974) 13 Pa Cmwlth 135, 317 A2d 917; Pennsylvania Pub. Utility Commission v Duquesne Light Co. R-80011069, Feb. 20, 1981. In availing ourselves of this generally accepted method of arriving at a fair rate of return, we first determine the sources of utility's capital. We then determine the cost of each component; namely, the cost of debt, the cost of preferred stock, and the cost of common stock (common equity). The latter being determined by the return required to sell such stock upon reasonable terms in the market. Pennsylvania Pub. Utility Commission v Pennsylvania Power Co. R-811510 Jan. 22, 1982.

Regardless of the procedure employed in determining fair rate of return, we must exercise "informed judgement." As we stated in Pennsylvania Power:

"The return finding should consider the financial costs being incurred, so that the utility has the opportunity to recover its present cost of capital or to attract needed capital at reasonable cost. A fair rate of return for a public utility, however, is not a matter which is to be determined by the application of a mathematical formula. *It requires the exercise of informed judgement* based upon an evaluation of the particular facts presented in

each proceeding. There is no one precise answer to the question as to what constitutes proper rate of return. The interests of the company and its investors are to be considered along with those of the customers, all to the end of assuring adequate service to the public at the least cost, while at the same time maintaining the financial integrity of the utility involved." (Emphasis supplied.)

Moreover, we must adhere to the legal constraints which guide our decision.

In the landmark case of Bluefield Water Works & Improv. Co. v West Virginia Pub. Service Commission, 262 US 679, PUR1923D 11, 67 L Ed 1176, 43 S Ct 675, the United States Supreme Court addressed the issue of fair rate of return for a public utility. In Bluefield, the court stated:

"What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgement, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country in investments in other business undertakings which are attended by corresponding risk and uncertainities [sic]; but it has no constitutional rights to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate under efficient and economical management, to maintain and support its credit and enable it to raise

the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time, and become too high or too low by changes affecting opportunities for investment, the money market, and business generally." Id., 262 US at pp. 692, 693.

In establishing the standards to be applied in implementing the federal Natural Gas Act, the United States Supreme Court, in Federal Power Commission v Hope Nat. Gas Co. (1944) 320 US 591, 51 PUR NS at pp. 200, 201, 88 L Ed 333, 64 S Ct 281, said:

"The rate-making process, under the act—i.e., the fixing of 'just and reasonable' rates—involves a balancing of the investor and the consumer interest. . . . [R]egulation does not ensure that the business shall produce net revenues. [Citations omitted.]

"But such considerations aside, the investor interest has legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include services on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. The return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." Id., 320 US at p. 603.

As noted in these cases, we are required to approve as just and reasonable, rates which will produce revenues sufficient to enable the utility to recover all reasonable operating and maintenance expenses, depreciation, and

taxes. Additionally, the utility is entitled to have an opportunity to earn a fair rate of return on the capital invested in the enterprise. Pennsylvania Pub. Utility Commission v North Penn Gas Co. R-80111375, Dec. 9, 1981. We stated in Pennsylvania Pub. Utility Commission v Philadelphia Electric Co. R.I.D. 438, Feb. 5, 1979:

"Among the factors to be considered in determining a fair return are (1) the earnings which are necessary to assure confidence in the financial integrity of the utility and to maintain its credit standing; (2) the payment of dividends and interest; and (3) the amount of the investment, the size and nature of the utility, its business and financial risks, and the circumstances attending its origin, development, and operation."

Finally we must engage in an appropriate balancing of the rates charged to the customers, for the service provided, with the return to which investors in the enterprise are entitled to have an opportunity to earn.

A. *Capital Structure*

The capital structures proposed by Duquesne, the OCA, and staff are set forth below:

Type of Capital	*Duquesne Light Per Cent*	*OCA Per Cent*	*Trial Staff Per Cent*
Debt	51.5	51.47	51.5
Preferred and Preference Stock	13.4	13.45	13.4
Common Equity	35.1	35.0	35.1
	100.0	100.0	100.0

Staff's proposed capital structure is identical, and the OCA's ratios are not materially different, from those proposed by the respondent's rate of return witness, Joseph F. Brennan.

The ALJ recommended adoption of Duquesne's proposed capital structure. No party has excepted. We find that the recommended capital structure is reasonable and adopt it for this proceeding.

B. *Cost of Debt*

Duquesne's rate of return witness, Mr. Brennan, initially estimated the composite cost of long-term debt, as of December 31, 1982, to be 9.44 per cent, under the assumption that the planned April, 1982, sale of $65 million of first mortgage bonds would carry an interest rate of 16.50 per cent. Duquesne states that these first mortgage bonds actually sold at a rate of 16.25 per cent, not the 16.50 per cent originally estimated by Mr. Brennan. Staff's rate of return witness, Kenneth J. Schiavo, included in his calculations of respondent's embedded cost of debt, the lower actual interest expense associated with this first mortgage bond issuance. Both parties now agree that a cost of 9.42 per cent accurately reflects Duquesne's embedded cost of debt.

The ALJ has concluded that the respondent's estimate reflects the latest actual experienced embedded cost of debt and recommended that it be used. No exceptions have been filed by any party.

We conclude that 9.42 per cent is a reasonable composite debt cost rate and we adopted it for use in this proceeding.

C. *Cost of Preferred and Preference Stock*

For preferred and preference stock, Duquesne estimated a composite embedded cost rate of 8.41 per cent as of December 31, 1982. The 8.41 per cent cost rate reflects the planned $25 million sale of preference stock which Duquesne has assumed will have an effective cost

rate of 16.16 per cent. While the OCA has adopted the respondent's recommendation, staff contended that a reasonable cost rate for preferred and preference stock is 8.33 per cent, which was based on an assumed 15.15 per cent effective cost rate for the planned $25 million sale of preference stock.

The ALJ considered staff's estimate to appropriately reflect the recent decline in the prime rate and money market rates and, accordingly, recommended 8.33 per cent as the effective cost rate for preferred and preference stock. No exceptions have been filed by any party. Finding it reasonable, we adopt the ALJ's recommended 8.33 per cent cost rate.

D. *Cost of Common Equity*

When addressing the issue of equity returns, we have come to expect a wide range of cost estimates. Therefore, the controversy which surrounds the determination of the cost of common equity in this proceeding is to be expected.

The respondent's witness, Mr. Brennan, recommended, as reasonable, a common equity cost rate of 18 per cent. Mr. Brennan's recommendation is based upon a discounted cash-flow (DCF) calculation of 16.7 per cent and a refined bare-rent calculation of 17 per cent, which when weighted equally produces 16.9 per cent. This figure of 16.9 per cent was then adjusted to a rate which would be sufficient to permit the respondent's stock to trade at approximately 103 per cent to 110 per cent of book value, a level deemed reasonable by the witness. This adjustment to respondent's recommended DCF calculation produced a final DCF range of 17.4 per cent to 18.6 per cent. The witness has selected the midpoint of this range as his recommended cost of common equity.

The OCA witness, Mr. Rothschild, recommended in his original prepared testimony a 15.25 per cent return on common equity. This equity return rate was the midpoint of his DCF and capital earnings pricing technique (CEPT) findings. At the hearing on October 7, 1982, Mr. Rothschild stated that as of that date he would revise his recommendation downward to a range of 14.5 per cent to 15 per cent to reflect current market conditions.

Originally, staff witness, Mr. Schiavo, recommended a 16.4 per cent return on common equity. After considering recent market data and his judgement regarding the near-term trend for money market rates and the price of Duquesne's stock, Mr. Schiavo concluded, at the September 16, 1982, hearing, that 15.8 per cent would best approximate Duquesne's prospective cost of common equity. In arriving at this equity return of 15.8 per cent, Mr. Schiavo relied upon the DCF and capital asset pricing model (CAPM) methodologies. Mr. Schiavo applied these methodologies to Duquesne and a barometer group of four electric utilities. For Duquesne, Mr. Schiavo's DCF computation yielded a 15.5 per cent cost of common equity while the CAPM yielded 15.6 per cent. Mr. Schiavo selected the rounded midpoint of these two methodologies to arrive at 15.6 per cent. Mr. Schiavo's application of both the DCF and the CAPM methods, to the barometer group, yielded a cost rate of 15.9 per cent. Mr. Schiavo's overall average cost rate for common equity (15.8 per cent) was computed by taking the rounded midpoint of the above mentioned averages of 15.6 per cent and 15.9 per cent.

1. *Discounted Cash Flow*

The DCF analysis is a market-based technique which is founded upon the principle that the amount an

investor will pay for a share of common stock is based upon the present value of anticipated future dividends and appreciation in market price. Pennsylvania Pub. Utility Commission v Dauphin Consol. Water Supply Co. R-80061242, April 3, 1981; Pennsylvania Pub. Utility Commission v Pennsylvania Power Co. R-811510, Jan. 22, 1982. In theory, the DCF method analyzes what an investor expects to receive as opposed to what an investor would like to receive as a return on the investment made.

The DCF methodology is not without its infirmities. The market price of a stock reflects both the current and future investor expectations regarding growth in earnings and hence dividends. Therefore, a separate consideration of growth rates, either in earnings, dividends, or book value reflective of earnings retention, could result in the duplication of a growth estimate which is already reflected, in part at least, in market price. Moreover, normally, market price will also reflect present inflation and an assumption of future inflation. Pennsylvania Pub. Utility Commission v Pennsylvania Power Co. R-811510.

Duquesne's witness, Mr. Brennan, arrived at a common equity cost rate of 16.7 per cent (before adjustment for market pressure and issuance expenses) using the DCF method. Based on an observable recent trend indicating a four cents a year increase in Duquesne's annual dividend, Mr. Brennan assumed the current annual dividend per share of $1.90 would increase by 2 per cent to $1.94. Utilizing an annual dividend of $1.94 and the then current price of common stock of $13.25 (April 8, 1982) witness Brennan calculated a dividend yield of 14.6 per cent. A dividend yield of 15 per cent was then calculated by using the average dividend yield for the

twelve months ending March 31, 1982, while retaining the 2 per cent dividend growth factor. A dividend yield of 14.8 per cent was calculated by Mr. Brennan by averaging the dividend yields of 14.6 per cent and 15 per cent.

Mr. Brennan then removed the 2 per cent, dividend growth assumption and calculated a dividend yield of 14.5 per cent by averaging the 14.7 per cent average dividend yield for the twelve months ending March 31, 1982, and a 14.3 per cent dividend yield based upon a spot price at April 8, 1982. Averaging the 14.8 per cent derived above with the 14.5 per cent derived here, Mr. Brennan arrived at the 14.7 per cent dividend yield to be utilized in his DCF computation.

A growth factor for the DCF formula, of 2 per cent, was determined by Mr. Brennan on the basis of forecasted dividend and earnings growth rates. By combining the average dividend yield of 14.7 per cent and the growth rate of 2 per cent, Mr. Brennan arrives at his unadjusted, DCF-derived, common equity cost rate of 16.7 per cent.

The staff presented a DCF analysis which resulted in a 15.5 per cent cost of common equity. Staff's witness, Mr. Schiavo, calculated a 13.5 per cent dividend yield based upon a $14.125 market price for Duquesne's stock on September 10, 1982, and the current $1.90 per year dividend. The staff asserts that the use of the $14.125 market price represents Mr. Schiavo's best judgement as to the mean or average price for Duquesne stock during the near-term future. In addition, the market price also represents the effect that the drop in money market rates has had on electric utility stock prices. Mr. Schiavo used a 2 per cent growth factor after con-

sidering the historic 1975-82 compound growth rate in dividends per share for Duquesne, the Value Line 1979-81 to 1985-87 dividend rate estimate, and Salomon Brothers' predicted dividend per share over the next full year. Mr. Schiavo's representative dividend yield of 13.5 per cent and his 2 per cent prospective growth rate yielded a DCF-indicated rate of 15.5 per cent. The staff also stated that had Mr. Schiavo used a $1.94 projected dividend per share instead of the $1.90 current dividend per share, the return on common equity for Duquesne would be 15.7 per cent. The staff notes that both results are within the 15.8 per cent common equity cost rate recommended by Mr. Schiavo.

The OCA witness, Mr. Rothschild, recommended a common equity cost rate within the range of 13.9 per cent to 14.4 per cent, based upon the application of the DCF method to the Moody's 24 Public Utilities (before adjustment for financing costs and risk differential). Mr. Rothschild determined that a dividend yield of 12 per cent and growth rates ranging from 1.9 per cent to 2.4 per cent were reasonable. After the adjustments were made for financing costs and market pressure (0.3 per cent), and capital structure risk differential (0.3 per cent), Mr. Rothschild recommended a range of 14.5 per cent to 15 per cent for a DCF-based cost of common equity rate.

2. *Risk Spread Analysis*

Mr. Brennan considered his risk spread analysis to be a refinement of the bare-rent approach. The bare rent theory states that there are three costs to an equity investment, (1) bare rent or the basic time cost (value) of money; (2) an inflation factor; and, (3) the risk element (equity risk premium) to reflect the degree of

risk inherent in the difference between a low risk, near guaranteed obligation, such as a utility long-term debt investment, and a utility common stock investment.

Mr. Brennan's methodology is based on the premise that there is a risk spread between the cost rate for bonds and the cost rate for common equity capital. By combining an estimated 15 per cent cost rate for A-rated bonds as of December 31, 1982, and a 2 per cent risk spread between bonds and common equity capital, Mr. Brennan proposes a cost rate for common equity capital of 17 per cent, before selling and issuance expenses.

3. *Capital Asset Pricing Model (CAPM)*

Staff presented a capital asset pricing model (CAPM) analysis. The CAPM is based on the principal that the cost of common equity is equal to the risk-free cost of capital plus a market premium for the risk associated with the particular stock under study. Mr. Schiavo used the average of recent yields and future prices on three-month Treasury bills for the risk-free rate. Mr. Schiavo used three-month Treasury bills because of his belief that they possess the three important characteristics required of a riskless asset:

(1) the rates are market determined,

(2) the risk of default is minimal, and

(3) the term to maturity is relatively short to minimize the risk of price change and capital loss. The data yielded a current risk-free rate of 11.905 per cent.

Mr. Schiavo calculated the relative market premium for the stock under study by multiplying its beta (0.55) times the equity risk premium for the market as a whole. A 6.733 per cent equity risk premium was

developed by Mr. Schiavo by averaging the differences between Standard & Poor's (S&P) 399 expected DCF returns on equity and three-month Treasury bills over an 11-year period, 1969 through 1979. Mr. Schiavo's alternative of the Dow-Jones 29 data produces an equity risk premium of 6.571 per cent. In order to develop an appropriate cost of common equity under this methodology, Mr. Schiavo, multiplied his risk premiums 6.733 per cent and 6.571 per cent by the beta factor of 0.55. These results, when added to Mr. Schiavo's risk-free rate of 11.905 per cent yields his common equity cost rates of 15.61 per cent and 15.52 per cent, respectively. Applying the CAPM technique to Mr. Schiavo's barometer group (of four electrics) produced common equity cost rates of 15.95 per cent and 15.85 per cent, respectively.

4. *Comparable Earnings Pricing Technique (CEPT)*

The OCA witness, Mr. Rothschild, also used a comparable earnings pricing technique (CEPT) to calculate the cost of common equity. Mr. Rothschild states that this method is based upon an observable phenomenon in the marketplace which is "that the market-to-book ratio achieved by a company is a function of the return on equity a company will be able to earn in the future." Mr. Rothschild ascertained that the return achieved and earned by companies with a market-to-book ratio of 1.00 varied within the range of 13.12 per cent to 13.89 per cent. Mr. Rothschild had used a data base consisting of the S&P 500 plus 400 other companies believed by S&P to be of high investor interest.

After considering that the earned return on equity for industrial companies is less stable than for utilities, Mr. Rothschild normalized the industrial-based data and

proposed a cost of equity of approximately 15.5 per cent. However, Mr. Rothschild concluded that "the CEPT results should indicate a higher than appropriate level for the costs of equity of an electric utility."

E. *ALJ's Recommendation and Exceptions*

1. *DCF Method*

In arriving at an appropriate cost rate for common equity, the ALJ averaged the results of his recommended cost rates for both the DCF and risk spread methodologies.

Based on the DCF methodology, the ALJ recommended the use of a 16.25 per cent cost rate for common equity. This cost rate reflects the use of a dividend yield of 14.25 per cent and 2 per cent growth rate used by both Duquesne and the staff.

The respondent, staff, and the OCA have all excepted to the ALJ's recommendation.

Duquesne argues that the ALJ has failed to update his growth rate estimate of 2 per cent to reflect the investors' increasing growth rate expectations. Duquesne explains that the rise in investor expectations is due to increased stock market prices and reduced current spot dividend yields. Duquesne contends that current financial estimates indicate growth rates as high as 5 per cent.

The staff takes exception to the ALJ's use of an average of the average dividend yield for the 52-week period *ended March 31, 1982*, and the September 10, 1982, projected dividend yield. The staff argues that a consistent analysis would use the average of the average dividend yield for the 52-week period *ended September 10, 1982*, and the September 10, 1982, projected

dividend yields, since this was the date for which the projected dividend yield was derived. The use of a 52-week average dividend yield at September 10, 1982, produces a 16 per cent DCF common equity cost rate.

2. *Risk Spread*

The ALJ also developed a common equity cost rate using the risk spread methodology. Based on this method, the ALJ recommended the use of a 16.2 per cent cost rate. This cost of common equity reflects the use of a debt cost rate of 14.02 per cent and a 2 per cent common equity risk premium.

The ALJ agreed with the bond cost rate of 15 per cent, used by Duquesne witness Brennan, but did not consider his debt cost to accurately reflect current market conditions. However, after recognizing the "hazards of undue reliance on spot price data," the ALJ gave Mr. Brennan's estimate equal weight with more recent data indicating that A-rate bonds have produced yields of 13.04 per cent. (*Wall Street Journal,* November 9, 1982, p. 45). The ALJ's average of the historical (15 per cent) and recent (13.04 per cent) data results in debt cost rate of 14.02 per cent. Finally, the ALJ used the 2 per cent common equity risk premium proposed by Mr. Brennan, which he considered to be the best estimate of that factor on the record and arrived at his 16.02 per cent result.

The respondent excepts to the ALJ's risk spread analysis because it allegedly overlooks the relationships between the spread and the cost of debt. The respondent contends that the ALJ has understated the risk spread cost of common equity by his failure to adjust the risk spread upward to reflect a decrease in his estimated cost rate for A-rated bonds.

Staff argues, in its exceptions, that there is no evidence that bond rates will, in the near-term future, return to the higher 15 per cent cost rates estimated by Mr. Brennan. Therefore, staff contends that Mr. Brennan's erroneous estimate is entitled to no weight and the risk spread analysis supports a common equity cost rate for Duquesne of no more than 15.5 per cent.

The average of the cost rates using the ALJ's DCF analysis (16.25 per cent) and risk spread analysis (16.02 per cent) results in the common equity cost rate of 16.14 per cent recommended by the ALJ. Furthermore, the ALJ agreed with the staff that the market price of a stock fully reflects selling and issuance expenses and underwriting discounts and commissions.

The respondent excepts to this conclusion asserting that the commission has recognized in Pennsylvania Power, R-811510 that issuance costs do exist. Therefore, respondent argues that since they exist an allowance must be made for them and the only way respondent can recover market pressure and selling and issuance expenses is by their inclusion in the cost rate for common equity.

Staff has also excepted to the ALJ's failure to rely on Mr. Schiavo's CAPM cost of common equity analysis. The OCA's exceptions argue that the ALJ's recommended cost rate for common equity of 16.14 per cent is "overly generous to utility equity holders at the expense of Duquesne's hard-hit consumers of all classes."

F. *Conclusion*

Before commencing our analysis of the various allowances urged by the parties, it is worthwhile to reiterate our goal, which is to be fair to the stockholders, and fair to the ratepayers, and to achieve proper balance between these two conflicting interests.

1. *Discounted Cash Flow*

A DCF analysis is based upon two component parts: dividend yield and an investor-expected long-term dividend growth rate. A dividend yield calculation, being a function of the dividend declared by a utility and the market price of that stock, may be influenced by a variety of factors. As the dividend paid by a utility is not subject to daily fluctuations, the selection of an appropriate market price is of prime importance. Pennsylvania Pub. Utility Commission v Philadelphia Electric Co. R-811626, May 21, 1982.

The respondent's witness, Mr. Brennan, calculated a dividend yield based on equal weighting of dividend yield at April 8, 1982, and the average dividend yield for the twelve months ending March 31, 1982. We consider this data dated and therefore of questionable value. The market price data utilized by Mr. Brennan is not representative of the current market price of Duquesne stock. The ALJ concluded that Mr. Brennan's selection of market prices did not reflect the substantial decrease in money market rates and the increase in electric utility stock prices since August, 1982. We agree with the ALJ that the dividend yield employed in this proceeding should reflect more current market data.

The respondent has also misinterpreted our decision in Re Philadelphia Electric Co. R-811719, and ascribed to it a precedential value which it does not have. Based on the record *in that* proceeding, we utilized a 52-week market price average instead of spot data in calculating an appropriate dividend yield. However, we were not following an "established" commission policy in making that determination. There we considered the spot stock

price too low to be an adequate indicator of the prospective market price level. In that case, as has been our practice in determining the cost of common equity, we made an individual analysis in arriving at our conclusion. Here, the sharp decline in the prime lending and other money market rates is a factor which cannot be ignored, and an identical analysis methodology does not appear to be appropriate here. Our comments would be incomplete if we did not also state, that in some instances, reliance on spot data may produce results which have only short-term validity.

In order to insulate his DCF analysis from short-term economic situations, the ALJ also utilized a 52-week average dividend yield in his computation. We agree with the ALJ that this average should be employed to mitigate potential abnormalities that strict reliance upon spot data may produce. Pennsylvania Pub. Utility Commission v Pennsylvania Gas & Water Co. (1981) 55 Pa PUC —.

Accordingly, we adopt the ALJ's recommendation that a dividend yield of 14.25 per cent be utilized as the first component in a DCF analysis of the cost of common equity. We conclude that a dividend yield of 14.25 per cent is reflective of the current as well as the longer term dividend yield which is presently a reasonable expectation by investors.

The second component, the growth rate, which was adopted by the ALJ was 2 per cent. We agree that a 2 per cent growth rate is reasonable and represents growth expectations of investors in the near to middle term.

Therefore, we shall adopt for our use in determining an appropriate cost rate for common equity, the

ALJ's recommended 16.25 per cent cost rate based upon the DCF methodology.

2. *Risk Spread Analysis*

We shall also adopt, for our use in determining an appropriate cost rate for common equity, the ALJ's recommended 16.02 per cent cost rate based on the risk spread methodology. The ALJ's debt cost rate of 14.02 per cent, does in our view, correctly reflect current market conditions and recognize the possibility that the current lower rate may only be indicative of short-term economic conditions. We reject the staff's argument that respondent's 15 per cent estimated cost rate for A-rated utility bonds is entitled to no weight in an analysis.

In addition, we agree that the 2 per cent common equity risk premium is the best estimate of that factor on the record. The respondent's argument that the risk premium should be increased to reflect either the decline in dividend yields or bond yields, is rejected as being without foundation in the record.

3. *Capital Asset Pricing Model*

The staff used the average of recent yields and future prices on three-month Treasury bills for its risk-free rate. We reject that conclusion because such short-term obligations are also reflective of extraneous factors such as essentially the spot money supply.

4. *Comparable Earnings Price Technique*

This technique of Mr. Rothschild's is new and novel. It appears to us that the product of this technique is a stated earnings rate which will enable common equity to sell at book value. Since we do not consider such a result the objective of our search, we do not perceive that the result of this analysis is of any value to us here.

5. *Conclusion*

Based upon our analysis of the various common equity cost rate methodologies recommended by the parties and the ALJ in this proceeding, we conclude that the *midpoint* of the results of the ALJ's DCF analysis (16.25 per cent) and ALJ's risk spread analysis (16.02 per cent) is an appropriate cost of common equity to adopt in this proceeding. Accordingly, we shall utilize 16.14 per cent as our cost of common equity, which, combined with our findings capital structure, cost of debt, and cost of preferred, stock yields an overall return of 11.64 per cent.

Finally, we agree with the ALJ that no special allowance is required for issuance costs. Pennsylvania Pub. Utility Commission v Philadelphia Electric Co. R-811626, May 21, 1982. In Pennsylvania Pub. Utility Commission v Pennsylvania Power Co. R-811510, Jan. 22, 1982, while we concluded that issuance expenses do exist, we also concluded that such costs are reflected in the market price of company's stock. We have not been persuaded here that our position was incorrect.

To the extent inconsistent with our various stated conclusions, the exceptions of the parties are denied.

VI. *Rate Structure*

Witnesses sponsored by the company, the staff, the OCA, the commercial customers, and United States Steel have testified regarding the most appropriate manner of allocating the revenue increase to be granted herein to the various customer classes.

A. *Cost-of-service Study*

A cost-of-service study is a procedure for the allocation of plant investment, revenues, and expenses to

classes of service. Such a study serves as a foundation or beginning point in the determination of just and reasonable rates and consists of three steps: functionalization, classification, and allocation. Functionalization is the separation of plant or costs into the major functions such as power production, transmission, and distribution. The second step, classification, is the separation of plant and costs into categories which recognize service characteristics such as demand, energy consumption, and number of customers. The third and final step, allocation, is the assignment of the functionalized and classified plant and expenses to particular rate classes.

In our opinion and order in Duquesne's last rate proceeding at R-811470, April 19, 1982, we looked closely at the company's cost-of-service study. With respect to the allocation of demand-related production plant, we found that the company's use of the average and excess methodology was reasonable.

With respect to distribution plant and general plant (Accounts 389 to 392 and 397) we directed:

"3. That Duquesne Light Company shall present a definitive study and/or analysis as a substitute for the current assumptions used for distribution accounts in the cost-of-service study in its next general rate increase proceeding.

"4. That Duquesne Light Company shall perform a study reevaluating the current division of General Plant Accounts 389, 390, 391, 392, and 397 between customer and transmission/distribution components by means of a survey and analysis of plant functions in order to ascertain:

"(a) whether the present division is appropriate; and,

"(b) whether the production component in these accounts should be identified as a separate plant function.

"The results of this study shall be presented in Duquesne's next general rate increase proceeding." Id., at p. 34.

In this proceeding, Duquesne presented a complete cost-of-service study. Duquesne witness Richard H. Pierce, vice president of Associated Utility Services, Inc., audited the company's prior cost-of-service methodology, proposed revisions to existing techniques, and assisted in the preparation of the cost analysis for the recorded test-year 1981, under present and proposed rates. The results of Mr. Pierce's analysis and study are contained in Duquesne Exh No. IV, Item IV-C-15. Mr. Pierce made the following revisions to the prior Duquesne cost-of-service study:

1. The demand component of cost utilized for the functionalized distribution plant and the minor amount of transmission plant has been allocated to classes of service on the noncoincident demand method of allocation.

2. Production plant has been classified as demand and energy related.

3. A revised methodology has been utilized for the classification of the demand and customer components of distribution plant and expenses.

4. Certain maintenance costs in the production function have been changed from demand related to energy related.

5. A functional study for each of the general plant accounts has been made for classification and allocation.

6. Each attachment or delivery point from the Duquesne system has been assigned a customer component of cost.

While Duquesne has described these revisions as "minor," they have raised considerable controversy.

1. *Allocation of Demand-related Plant*

Duquesne Exh No. IV, Item No. IV-C-15, contains the fully distributed cost-of-service study summaries. In addition to the average and excess demand, average demand, noncoincident peak, and coincident peak responsibility methodologies required by commission regulations, Duquesne has presented a study which uses the average and excess demand method for plant and expense items functionalized and classified as power supply demand, and the class noncoincident demand methodology for all other demand-related items. Duquesne's position is that the selection of a specific demand cost allocation methodology should be based on the characteristics of the utility and its customers and should include consideration of the following criteria:

(1) The method should recognize kilowatt demand, kilowatt-hour energy consumption and time of use of service.

(2) The method should recognize the characteristics of the various customer class loads supplied by the utility.

(3) The method should produce stable results.

As mentioned above, in this proceeding Duquesne has chosen to allocate power supply demand-related plant and expenses using the average and excess methodology, and to allocate all other demand-related plant and expenses using class noncoincident peak demands.

2. *Classification of Production Plant and Expenses*

Production is one of the main cost functions of any cost-of-service study. Fixed production costs are typically classified as demand-related costs in cost-of-service studies. After analysis, however, Mr. Pierce concluded that certain of the company's production plant and expenses should be classified as, and allocated on, an energy, rather than a demand basis. The vast majority of production plant and expenses (92 per cent) was classified as, and allocated on, a demand basis.

Because of its high daily and annual load factor, its relatively small summer-winter peak differential, and its customer mix, Duquesne chose to allocate demand-related production plant and expenses using the average and excess methodology. The average and excess method of demand cost allocation distributes a portion of total demand responsibility according to the average demand of each class of service. The average and excess demand method was described in Duquesne Exh No. IV as follows:

"*Average and Excess Demand Method*

"The average and excess demand method allocates demand costs in a two-part formula. A portion of demand costs is allocated based on the average demands of the classes. The remaining demand costs are allocated based on the excess of class maximum demands over class average demand. This method has the advantage of recognizing the impact on costs of both energy consumption and maximum demand. By considering both energy and demand, the importance of class load factor, or relative use of facilities, is incorporated into the study. Diversity is also considered with the benefit of diversity allocated on the basis of load

factor. The low load factor customers receive a greater proportion of the benefits of diversity. One of the most important advantages of this method is that stable results are produced. This is particularly critical on a system such as Duquesne's, where one or more customers with extremely large loads can drastically affect the system peak at any time. In the average and excess method the loads composing the system peak are not considered, but class peaks, which are generally more stable, are used. It is Duquesne's opinion that the average and excess demand method meets more of the selection criteria than other available methods and, therefore, is the method most appropriate for Duquesne's system for power production and transmission plant."

In support of the reasonableness of the average and excess methodology as the method of allocating demand-related production plant and expenses, Duquesne states that the important factor to remember is that, unlike peak demand methodologies, the average and excess method, as its descriptive name indicates, allocates a portion of total demand responsibility on an average demand or energy basis, thereby reducing the totality of costs allocated on a demand, as opposed to an energy, basis. Duquesne also states that the commission has expressed a preference for demand allocation methodologies which give some recognition to average demand as compared with those methodologies which rely solely on peak demand allocators, and that its average and excess demand methodology was considered and approved in its last two rate proceedings at R-80011069 and R-811470.

Although the OCA uses the term "peak and average demand" in describing Dr. Stutz's method, his method is, in reality, the average and excess methodology

using the peak demand method to allocate the excess demand as contrasted with noncoincident demand method used by Mr. Pierce for Duquesne. The OCA's position is that only by using the coincident peak method of allocating excess demand "can the actual diversity of the system be accurately reflected and properly allocated."

We perceive no dispute between Duquesne and the OCA that, by allocating average demand upon an energy basis, diversity is at least partially recognized. The OCA witness proposes that the excess demand be allocated on the coincident peak method in order to further and more accurately recognize diversity. On the other hand, Mr. Pierce selected the noncoincident peak method to measure the *use* each class member made of the remainder of production plant.

In our view, the selection of the *appropriate* cost allocation method is largely a matter of judgement rather than a matter of right or wrong or a correct or incorrect methodology. Apparently, while recognizing that the method allocated by Duquesne recognizes diversity, in the view of the OCA, the method advocated by Dr. Stutz more equitably allocates "the benefits of diversity to those classes who create them."

The ALJ recommended adoption of the company's methodology, relying, in large part, upon our action and comments in our opinion and order in the prior Duquesne proceeding at R-811470, April 15, 1982.

The OCA has excepted. In its exceptions the OCA, in arguing in favor of the peak and average methodology of its witness, Stutz, and against the average and excess methodology used by the company, characterized the company's method as having "no contact with

the realities of Duquesne's system planning nor the actual cost incurrance [sic] on its system" and that it "fails to properly reflect diversity on its system and penalizes low load factor customers." Further, that "the record offers no support for the contention that the average and excess method is necessary for rate stability." In conclusion, the OCA offers the fact that its proposed peak and average method has been adopted in New Jersey, North Carolina, and Texas and should be adopted by us.

We shall address this and all other exceptions to the ALJ's recommended decision in our conclusionary paragraph.

3. *Energy-related Production Plant and Expenses*

In Duquesne's cost-of-service study in this proceeding, all generating facilities were functionalized to the production function. Within the production function, however, fuel-handling facilities included within production plant accounts, frequently treated as demand related, were classified as energy related. In support of the classification of fuel-handling facilities as energy related and allocating them on that basis, Mr. Pierce offered the following rationale:

" . . consider two coal-burning utilities. One has a unit coal train to deliver the coal and the other purchases the coal delivered to the yard. The cost of the coal at the mine may be the same to both utilities. The utility that purchases the coal at the yard will have a higher energy cost because of transportation than the utility that owned the unit coal train. Correct classification of the unit coal train is to the energy component of cost not the fixed component of cost. This type of philosophy is required of plant and expense items in order to

assign them in a cost causative manner to match system characteristics and is superior to assigning all fixed costs to the demand component of cost."

In this proceeding, the classification of fuel-handling equipment as energy related, instead of demand related, involves $99,997,063 or 8 per cent of total production plant. This classification requires large energy users to bear a higher portion of the total costs than would be the case if fuel-handling equipment had been classified as demand related.

The commercial complainants presented George Gerasimou who testified on rebuttal against this departure from the National Association of Regulatory Utility Commissioners (NARUC) cost-of-service guidelines.

The ALJ recommended approval of the company's classification of fuel-handling equipment. The commercial complainants have excepted.

Mr. Gerasimou also disputed Mr. Pierce's recommended treatment of certain power maintenance expenses as energy related. The particular accounts there at issue are as follows:

Account		*Amount for Current Year 1981*
	Steam Power Generation	
(512)	Maintenance of Boiler Plant	$23,323,720
(513)	Maintenance of Electric Plant	6,781,556
(514)	Maintenance of Miscellaneous Steam Plant	2,487,411
	Nuclear Power Generation	
(529)	Maintenance of Structures	984,750
(530)	Maintenance of Reactor Plant Equipment	2,274,845
(531)	Maintenance of Electric Plant	999,776
(532)	Maintenance of Miscellaneous Nuclear Plant	999,415
	Other Power Generation	
(552)	Maintenance of Structures	118,306
(553)	Maintenance of Generating and Electric Plant	486,024
(554)	Maintenance of Miscellaneous Other Power Generation Plant	109,838

Of the ten accounts listed above, Mr. Gerasimou claims that four are classified as energy related contrary to NARUC recommendations.

The ALJ concluded, after review of the applicable parts of NARUC cost-of-service manual, that it appeared that of the $38,560,641 which the commercial complainants claimed had been misallocated, some $36,861,723 had, in fact, been classified in accordance with the NARUC manual. Of the four accounts which are classified as demand related by NARUC (Accounts 529, 552 to 554), the ALJ concluded that Duquesne made a reasonable case to the effect that these accounts are, in fact, energy related and should be classified as such. Consequently, he recommended approval of such classification.

The commercial complainants have excepted.

4. *Allocation of Distribution Plant*

In Duquesne's 1980 cost-of-service study submitted in the prior proceeding at R-811470, the company estimated that the 28.8 per cent of distribution plant was customer related. In our opinion and order therein, we directed that:

"3. That Duquesne Light Company shall present a definitive study and/or analysis as a substitute for the current assumptions used for distribution accounts in the cost-of-service study in its next general rate increase proceeding." Id. at p. 34.

In compliance with our opinion and order, Duquesne, through Mr. Pierce, sponsored a distribution plant classification study in which each of the distribution plant accounts was analyzed to determine the portion appropriately to be classified as customer related. The previously employed customer-related assumption for certain distribution plant accounts was replaced with a mathematical model based on the cost of labor to install the distribution system. The results of this study were incorporated into Duquesne's 1981 cost-of-service study. Using the mathematical model, the customer component was determined to be 34.3 per cent of distribution plant, while in the 1980 cost-of-service study only 28.8 per cent of distribution plant was estimated to be customer related. For the residential class the effect of this new customer component, because of changes in numbers of customers and other changes in classification, is to reduce its assignment of *total* distribution plant by 0.8 per cent from the 1980 study to 43.5 per cent currently.

It is Duquesne's position that since the zero intercept method of determining the customer component, which had long acceptance as a methodology until it began producing aberrant results because of inflation, basically represented the labor costs of installing the distribution system, it is appropriate to develop a computerized formula to determine the labor costs attributable to various distribution plant accounts. According to Duquesne, this methodology, is essentially nothing more than a modified zero intercept methodology. Duquesne's witness Pierce used this method to determine the customer component for Accounts 364 through 369.

The commercial complainants opposed this procedure on the basis that it only includes labor costs in the customer component and excludes consideration of any materials. The commercial complainants also argue that this approach is not recommended by NARUC. The company responds that modification of the zero in-

tercept methodology is necessary because, as a result of a decade of inflation, the zero intercept method results have moved into a negative position. The company also asserts that this methodology is entirely consistent with the spirit of the NARUC manual.

The OCA witness, Dr. Stutz, while acknowledging that the distribution system is constructed in response to two primary requirements—the need to serve customer's peak demands and the necessity to blanket the service area with conductors to allow connection of customers—enumerated two threshold questions regarding the derivation of a customer component:

"... First, can the costs of the distribution system be meaningfully divided into distinct components related to peak demands on one hand and the need to blanket the service area on the other? Second, if a reasonable method of separating the costs is available, on what basis should one allocate (and ultimately collect) the cost of blanketing?"

According to the OCA, the exercise assumes that costs of a distribution system can be meaningfully divided into distinct components. In the OCA's view, the character of the distribution system belies this assumption. As Dr. Stutz said:

"... The distribution system brings service to individual customers, each of whom: (a) must be connected to the system at his or her geographical position and (b) must be served through a system of sufficient capacity. Each requirement is meaningless without the other. The various techniques which attempt to divide distribution costs (whether those suggested by the NARUC manual or the alternative put forth by Mr. Pierce) suffer from a substantial flaw. They attempt to

attribute costs on the assumption that an imaginary world exists and is populated by customers willing to pay to be connected to an electric system which they do not use."

Thus, according to Dr. Stutz, there can be no meaningful division of these costs into demand and blanket functions since neither function is actually possible without the other. Therefore, he reasons, any such division put forward is, inherently, arbitrary.

In its main brief, the OCA refers to an industry task force which studied electric utility rate design, known as Task Force No. 4, jointly sponsored by the Electric Power Research Institute (EPRI) and the Edison Electric Institute (EEI) among others and performed for NARUC. The OCA states the task force, which consisted of twenty members representing state utility commissions, electric companies, service groups which perform cost-of-service studies for electric utilities, federal regulatory agencies, and EPRI, made two points. First, they noted that there is a substantial disagreement among experts as to what customer costs really are. Secondly, they noted that even where similar definitions of customer costs are adopted cost analysts produce dissimilar results. The task force's final recommendation was that, of the distribution costs, only services and meters should be considered customer related. The OCA further advises us that the task force stated: "By doing this we have eliminated the guess work of allocating certain costs between demand and customer."

The OCA then submits that the costs of blanketing the system cannot be accurately estimated, and that Mr. Pierce's methodology clearly illustrates the validity of the Task Force No. 4 recommendation. In addition it

argues that, even if the costs of blanketing the system could be estimated, his blanketing component is not properly classified as a customer cost and cannot be allocated accurately on the basis of the number of customers.

The OCA also argues that while the blanketing function derives from the need to serve the service area with a distribution system and is a function of the density of customers on the system its costs are not properly considered as customer-related costs.

In conclusion, the OCA argues that the commission must recognize the function of the distribution system and reject Mr. Pierce's "modified" zero or minimum intercept system as a measure of a phantom minimum distribution system that is little more than a theoretical exercise. Likewise it argues that distribution costs cannot be accurately divided into demand and blanketing functions and assuming, arguendo, that they could, the blanketing component of distribution costs cannot be allocated accurately to customer classes on the basis of the number of customers.

The OCA recommends, that in this case, the Task Force No. 4 recommendation be followed, and that mass distribution plant should be classified as entirely demand related.

Duquesne argues in response that the consumer advocate's contention that the separation of a portion of distribution plant into a customer component fails to recognize the function of the distribution system, is wrong. It cites United States Steel witness Lim, who, while recognizing that Mr. Pierce's methodology was not specifically set forth in the NARUC manual, supported Mr. Pierce's modified zero intercept methodology

as being the same conceptual methodology recognized in the NARUC manual, and explained how certain labor-related costs have no relationship to capacity to deliver maximum and lesser demands for electricity. In his view, these costs are appropriately considered as customer-related costs and should be allocated on that basis. As stated in Mr. Lim's direct testimony:

"It takes no extraordinary imagination to acknowledge that costs must be incurred, in planning, constructing, and operating a distribution system, which have no relationship to capacity to deliver maximum and lesser demands for electricity. Typically, they are comprised primarily of labor-related costs, the major component of installing electric distribution plant.

"The engineering cost and effort of completing two distribution system projects, of like configuration but different capacity, are practically the same. Similarly, apart from differences in equipment and facilities ratings and differences in size and weight attributable to such different ratings, the equipment and facilities are much the same and require the same time and man power to install. If overhead, poles must be placed, crossarms, hardware and insulators assembled, wires strung, transformers hung, etc., in a similar manner for both projects. If underground, the pavements and sidewalks must be broken, manholes and trenches dug, conduit laid, cable pulled, fittings installed and wrapped, ground repaired, and many other task [sic] performed which are essential to getting the system in place, without regard to its capacity. All of these activities would be required for each project, to be performed in similar fashion.

"Of course, actual projects are designed and built to particular capacity levels, and cost differences do

exist from differences in size and weight of facilities and machines. It is this type of difference which is measured by various zero intercept methods, whereby the change in cost associated with a change in capacity is determined for particular plant units in order to exclude such costs from the customer cost category. A careful zero intercept analysis, with adequate data and correct choices of increments to measure, provides an objective, reasoned result of what plant cost remains after elimination of that share of costs attributable to capacity characteristics.

"Whether such remaining plant cost is called a 'minimum system'—which seems to trouble Dr. Stutz—or something else such as noncapacity cost component of distribution system, is wholly beside the point. It is necessary to imagine the physical shape and appearance of a system costing the same as the 'minimum system,' because we are interested only in costs, not a hypothetical system. The point is that such costs exist, they can be measured, and they are not occasioned by design requirements for maximum demands.

"Any debate about their merits is properly directed only to how accurately they are determined, not whether they should be determined at all."

Relying in part upon our opinion and order in the Duquesne proceeding at R-811470 he concluded that Duquesne's study here is a reasonable attempt to measure a minimum customer component and recommended its adoption.

The commercial complainants except to the ALJ's approval of Duquesne's methodology; first, because it failed to classify any materials as customer related; and, second because it is not one of the two methods en-

dorsed in the NARUC cost allocation manual as appropriate for the determination of the customer classification of the distribution system.

The OCA excepted to the ALJ's recommendation on the basis that no portion of the distribution system should be classified as customer related with the possible exception of meters and services.

5. *Allocation of General Plant Accounts*

General plant includes all plant used for general purposes and which is not included in the FERC Uniform System of Accounts under production, transmission, or distribution functions.

In the 1980 cost-of-service study presented at R-811470, Duquesne estimated that 50 per cent of General Plant Accounts 389 to 392 and 397 were customer-related investment with the balance being classified in accordance with production, transmission, and distribution plant. Since there was a customer-related plant classification component in the distribution function, the company's prior method of classifying general plant resulted in 55.5 per cent of total general plant being allocated on a customer-related basis. In our opinion and order, at R-811470, we directed the company as follows:

"4. That Duquesne Light Company shall perform a study reevaluating the current division of General Plant Accounts 389, 390, 391, 392, and 397 between customer and transmission/distribution components by means of a survey and analysis of plant functions in order to ascertain:

"(a) Whether the present division is appropriate.

"(b) Whether the production component in these accounts should be identified as a separate plant function.

"The results of this study shall be presented in Duquesne's next general rate increase proceeding." Id. at 34.

In compliance therewith, Duquesne, through Mr. Pierce, presented a general plant functionalization study in which each of the general plant accounts was analyzed to determine the characteristics of the items included in the account. The items in each account were assigned to a functional category such as production, transmission, distribution, or customer accounts. The results of the study indicate that general plant investment is 59.5 per cent demand related, 39.2 per cent customer related, and 0.9 per cent energy related. The corresponding values used in the 1980 cost-of-service study submitted at R-811470 were 44.5 per cent demand related, 55.5 per cent customer related, and zero per cent energy related. The 1981 study results in a significant reduction in the customer component of investment in general plant. The results of the study were incorporated into the 1981 cost-of-service study included in Duquesne Exh No. IV Item IV-C-15.

As a result of the 1981 cost-of-service study, the customer component of general plant was reduced by $7,406,000 in spite of an increase in general plant investment of $10,586,000, with the investment primarily shifted into the demand component. Of the total general plant investment, 44.4 per cent is assigned to the residential class, 52.3 per cent to the general service class, and 3.3 per cent to the streetlighting class. In dollar terms, the residential class assignment of general plant is reduced by $7,396,000, below the 1980 assignment. In turn, the general service class assignment of general plant is increased by $16,937,000 over the 1980 value. A shift in the allocation of general plant from the residential class to the general service class is the result of the reduction in the total amount of investment which is classified as customer related. As explained in Duquesne Exh No. 22B, as more plant investment is classified demand related, the residential allocation decreases and the general service allocation increases.

The OCA states that the company's cost-of-service study move toward a more appropriate classification of these costs and does not argue against its use here. However, the OCA recommends that, even though the company's results not be modified for this case, the commission order Duquesne to continue to review this area, including administrative and general expenses (Accounts 920 to 923) and supervisory and engineering costs (Account 590) along with general plant accounts (Accounts 389 to 399), in a broader context than a strict embedded cost-of-service approach. The OCA would have us order Duquesne, in its next cost-of-service study, to consider this problem by: first, compiling a schedule of costs which are unrelated or only weakly related to one or more of the classification categories; and, second, by providing cost-of-service studies which allocate these costs on the basis of demand and energy.

The ALJ recommended approval of the company's classification methodology and finding no need for additional study rejected the OCA's request for an additional study. The OCA has excepted to the ALJ's recommendation against additional study regarding the appropriate classification of the enumerated areas of investment and expenses. The commercial complainants except to Duquesne's failure to follow NARUC guidelines regarding the classification of these accounts. Having carefully read the OCA request for an additional study regarding the classification of certain accounts, as set

forth in its main brief and the underlying testimony of Dr. Stutz at pp. 25-28 of OCA Statement No. 5, we find ourselves unable to formulate a directive as to how such a study should be performed, with sufficient specificity as to be a meaningful directive. Also, having considered Dr. Stutz's testimony at length, we conclude that any such study would be replete with subjective judgements. Consequently, we decline to direct any additional study.

6. *Conclusion*

In each area of contention regarding Duquesne's cost-of-service study, both as to its basic allocation methodology, by the OCA, and the antecedent classifications and the methodology employed therefore, the ALJ has recommended approval of the company's classifications, their methodology, and the ultimate allocation methodology employed. The OCA and the commercial complainants have excepted extensively and at length on several points. Because of the extent of the exceptions and the detail in which the parties would involve us in responding, details in which we do not believe it either necessary or appropriate to become involved, we feel it appropriate to express our views on the subject of cost-of-service studies in general.

A cost-of-service study is one of the most subjective elements in any rate case. The methods used for classifying items of plant and expense between demand, *customer*, and energy components are far from being an exact science. Cost-of-service studies are more accurately characterized as engineering art.

This commission has historically recognized the cost-of-service study for what it is: a useful tool for testing the reasonableness of the proposed allocation of the revenue requirement. Rarely, if ever, is revenue requirement allocated strictly on the basis of cost-of-service results. In most instances, and this case is no exception, the revenue allocation is based primarily on other factors such as economic impact and rate continuity with some modification due to cost-of-service considerations.

In this proceeding, different aspects of Duquesne's cost-of-service study have been vigorously challenged by the OCA and the commercial complainants. Plausible arguments have been made on both sides of a number of the issues that have been raised. The key question to be answered, however, is whether or not the company's study is, on the whole, acceptable, keeping in mind its limited purpose as a guide to the reasonableness of the revenue allocation.

Our conclusion on the issue of cost of service is that the company's study is generally acceptable in the context of this case. Accordingly, we adopt the various recommendations of the ALJ, and thereby the company's cost-of-service study, and deny the various exceptions of the parties.

B. *Specific Rate Structure Changes*

1. *Duquesne Proposals*

Using the cost-of-service study as a guide, and upon consideration of various other factors, Duquesne proposed the following changes in Tariff No. 15 schedules of rates and changes, and rules:

Rate RS—Residential Service

Unit prices have been increased.

Availability clause modified to clarify meaning.

Late payment charge on disputed bills was modified.

Special provisions revised to include residential garages.

Price differential for water heating block revised.

Rate RH—Residential Service Heating
Unit prices have been increased.
Availability clause modified to clarify meaning.
Late payment clause modified to clarify meaning.
Special provision revised to include residential garages.
Reference to months billed revised.
Price differential for water heating block revised.

Rate GS—General Service Small
Unit prices have been increased.

Rate GM—General Service Medium
First and second energy blocks have been combined.
Unit prices have been increased.

Rate GL—General Service Large

Rate GHR—General Service Heating (Restricted)

Rate I—Interruptible Power Service

Rate L—Large Power Service
Unit prices have been increased.

Rate GMH—General Service Medium Heating

Rate GLJ—General Service Large Heating
Unit prices have been increased.
Reference to months billed revised.

Rate SM—Streetlighting Municipal
Unit prices have been increased.
Freeze on installation of mercury vapor streetlighting.

Rate SE—Streetlighting Energy

Rate SH—Streetlighting (Highway)
Surcharge percentage has been increased.

Rate SR—Streetlighting (Restricted)
Surcharge percentage has been increased.

Rider 4—Budget Billing
Made applicable to Rates GM and GL.

Rider 8—Summer Service—Limited
Withdrawn from tariff.

Rider 9—School and Governmental Service
Maximum average charge and minimum charge have been changed resulting in increases.

Rider 10—State Tax Adjustment
Percentage has been increased.

Rider 12—Fuel Cost Adjustment

Rider 13—Emergency Energy Surcharge

Rider 14—Net Energy Clause
Withdrawn from tariff.

Rule 4—Contracts

Rule 5—Deposits and Advance Payments

Rule 8—Connection Charges

Rule 13.1—Underground Distribution
Revised to clarify meaning.

Rule 9—Relocation of Facilities
This rule was formerly Rule 8.1 in Tariff 14 and was revised to clarify meaning. Former Rule 9—distribution within a building from Tariff 14 has been withdrawn from the tariff.

Rule 13.3—Thermal Integrity and Insulation Standards
Temporarily suspended.

Rule 18—Redistribution
A clause encouraging energy conservation added.

Rule 21.2—Return Check Charge

New rule added to charge customer for a check returned to the company unpaid by the customer's bank.

Rule 24—Tampering

Payments shall include interest at the late payment charge rate.

Rule 41—Reconnection Charge

Rule revised and establishes a schedule of reconnection charges.

In summary the company proposed an increase of 24.4 per cent for residential service (RS and RS-WW) customers and 25.5 per cent for residential hearing (RH and RH-WW) customers. Rate GS was proposed to be increased by 27.6 per cent, Rate GM 23.8 per cent, Rate GL 24.6 per cent, Rate GHR 24 per cent, Rate GMH 22.7 per cent, Rule GLH 23.2 per cent, and, Rate L 21.8 per cent. The streetlighting customers would receive an increase ranging from 26.8 per cent (Rate SH) to 73.8 per cent (Rate SR).

The allocation of the operating revenue increases to the rate classes, as proposed in Tariff No. 15, was based on base revenues at zero fuel with each class receiving approximately the same percentage increase. After the operating revenue target had been determined for each rate class, the operating revenue target for each rate schedule within each rate class was established by applying the same percentage increase for each rate schedule. A review of the rate of return of each rate schedule was then made to determine if there were significant differences between the system average rate of return and rate of return from each rate schedule. If a significant difference was found, adjustments were made

to the targeted operating revenue increase in order that rate of return from each rate schedule would be closer to the system average rate of return.

The following adjustments were made by the company to the allocated revenues to bring the rates of return closer to the system average. Three million dollars were removed from the residential class with $2 million being added to Rate 1 in the general service class, $900,000 being added to Rate SE in the streetlighting class, and $100,000 being added to Rate SR also in the streetlighting class. Two million dollars were removed from Rate GM and added to Rate GL, both rates being in the general service class. One hundred thousand dollars were removed from SM and placed in SR, both rates being in the streetlighting class.

Under present rates the total system earns a 10.73 per cent return. Residential customers produce an 11.17 per cent return, Rate Class GS and GM earn 11.33 per cent, Rate GL 10.05 per cent, and Rate L 10.35 per cent.

Under the proposed rates the total system average would be a 15.73 per cent return. Residential classes would produce a 16.24 per cent return, Rate Classes GS and GM 16.18 per cent, Rate GL 14.93 per cent, and Rate L 15.39 per cent.

2. *OCA Proposals*

Dr. Stutz, the OCA witness, proposed that the return from residential customers be limited to 95 per cent of the system average. The basis for this proposal is that in his view Duquesne's industrial customers place a greater risk on Duquesne than do its other customers. Additionally, he proposed that the industrial customers of Duquesne, served under Rates GL and L, be

required to provide at least a system average rate of return.

This recommendation appears to be based on Dr. Stutz's interpretation of the testimony of Joseph Brennan, presented in other proceedings, in other jurisdictions. The company called Mr. Brennan in rebuttal to explain his prior testimony. Mr. Brennan's testimony with respect to the application of the theory of risk differential pricing in this proceeding is especially instructive:

"There is little doubt much more work must go forward before full implementation of tariff design can appropriately reflect rate of return differential by customer class. Moreover, sudden changes in pricing as a result of recognition of a new approach may need to be phased in gradually to minimize undue economic hardship and dislocation. It is possible to price a service so high by comparison with alternative choices as to be counterproductive to the enterprise and all of its customers. For instance, if the cost of electricity to industrial customers would not be competitive, or if the price of service to industrial companies resulted in the loss of the customer of expansion by the customer in the service territory of another electric company, the possible resultant reduction in load factor causing higher residential rates suggests a possible practical limit to the practice of full and immediate reflection of cost-based rate making."

In addition, Mr. Brennan stated:

"Given the apparent sad state of affairs with respect to some large customers served by Duquesne Light Company, it would seem counterproductive to all other customers viewed over the longer term to raise

the rate of return to large customers for pricing purposes certainly at this time as jobs may be lost, the load factor may be reduced, and over time residential rates may be higher than otherwise and my article in the FORTNIGHTLY clearly so indicated."

The ALJ recommended that the OCA proposal be rejected. In addition to the reasons stated above by Mr. Brennan, the ALJ founded his recommendation upon his conclusion that Mr. Stutz made no evaluation of the impact of the ratchet provisions in the tariff or the residential uncollectible factor in assigning risk to the various customer classes. Furthermore, he said, Duquesne's tariffs are not based on customer classes, but rather the size of customer demands, therefore, hospitals and schools, for example, are in the same class as large industrials, and that there would be no way to segregate industrial customers in order to assign them a higher return even if warranted. We agree with the ALJ that this proposal should be rejected. The OCA exception is, accordingly, denied.

OCA witness Stutz also proposed a change in the company's customer charge to reflect costs on a "customer only" basis. Under Dr. Stutz's proposal, the residential customer charge would be reduced from $4.95 per month to $3.92 per month. The company has proposed an increase in this charge to $6.35 monthly. Staff witness Rosenthal also considered this question and proposed that the $4.95 charge remain at its present level.

The company claims that the residential customer charge should reflect all those costs which are customer related and on this basis urges the increase to $6.35.

After reviewing the record, it was the ALJ's conclusion that Mr. Rosenthal's recommendation should be

adopted. He stated that in his view, a monthly customer charge should cover basic customer costs, excluding full consideration of the carrying charges on meters, services, and certain general plant, as well as the operation and maintenance expenses associated with meters, customer installations, meter reading, and customer records. The ALJ was also of the opinion that Mr. Rosenthal's methodology was consistent with our opinion and order in Pennsylvania Pub. Utility Commission v Philadelphia Electric Co. R-811626, May 21, 1982, and should be adopted here. The ALJ concluded, therefore, that any increase in the residential operating revenues was to be derived from increased kilowatt-hours charges. We agree with the ALJ. The residential customer charge shall be retained at its current level. The company's exception is denied.

3. *Staff Proposals*

In addition to its position on customer charges stated above, staff also proposed that the credit per kilowatt on Rider 7—interruptible service, be increased from $2 to $3. Increasing the credit to $3 would require a revenue increase from all other customer classes of $1 million.

Without discussing the merits of staff's proposal, it was the ALJ's view that in light of the economic conditions in the service territory, as evidenced by declining industrial sales and high unemployment rates, this proposal, which would increase the total revenue allowance, as well as the revenue contribution of residential and general service customers, should not be adopted at this time. We agree with the conclusions of the ALJ and, accordingly, the staff's exception is denied.

The staff, noting that Duquesne also proposed a 50 per cent base rate increase for Rate SE and a 73.8 per

cent increase fo. Rate SR, took the position that while these increases may be justified on a cost-of-service basis, any increase to these classes should be limited to 150 per cent of the system average increase.

The ALJ agreed with the staff position. His view was that cost-of-service considerations should be tempered by gradualism and that, as proposed by Duquesne, the revenue impact on these customers—municipalities operating under severe budgetary restrictions—would be substantial. The ALJ stated that the staff's proposal, while moving these customers towards the system average rate of return, recognizes that such a shift must be done without disruptive effects on the public interest. We reach the same conclusion as the ALJ, the increase for the streetlighting classes, individually, shall not exceed 150 per cent of the systemwide increase approved herein. The respondent's exception is accordingly denied.

VII. *Other Issues*

A. *Minimum Performance Standards—Beaver Valley No. 1*

In their main brief the commercial complainants stated that they have consistently opposed the inclusion of Beaver Valley I in rate base, based upon their assertion that the plant was not prepared to provide reliable service, and that history has proven them correct. Further, they state that Duquesne's management and investors have yet to be held to any standards of performance in operating this plant. The commercial complainants then urge that we "impose a requirement that Duquesne operate the plant to meet some minimum level of performance, or else be deprived of its full return on the plant as far as the ratepayers are concerned." Regarding the standards to be established, they state that their

prior suggestion that Duquesne be required to have the plant meet a capacity factor or availability factor of 60 per cent has been rejected as unrealistic. Here they assert "that the commission should, *utilizing its own skills,* establish some minimum level of performance for Duquesne to meet at the Beaver Valley No. 1 plant. The minimum standard should be considered by the commission in this proceeding in affixing (sic) Duquesne's rate of return."

The ALJ did not address this subject in his recommended decision. In their exception the commercial complainants state that they "continue to except to the nonexistance [sic] of any ongoing minimum performance standard to Duquesne should be held with respect to this one plant," asserting that we have the inherent power to set such minimum efficiency standards under the provisions of 66 Pa.C.S. § 1501.

Without engaging in an extensive discussion of the many factual scenarios and considerations, as well as rate-making considerations, which it would be necessary to address in developing an appropriate performance standard, and then to formulate and administer an appropriate sanction for failure to meet the standard, in whole or in part, one must state that we are impressed with the fact that the commercial complainants have suggested neither a specific standard, nor a specific sanction, nor have they suggested how any performance standard which might be adopted would be administered over time.

Having considered this subject we are of the opinion that the record in this proceeding is devoid of any basis upon which to adopt a performance standard with regard to Beaver Valley No. 1. Accordingly, the exception is denied.

B. *Residential Load Research*

The OCA states that, while it did not make any specific recommendations as to altered residential rate blocking, its witness, Dr. Stutz, did testify that the nature of Duquesne's residential load research did not permit the development of *an appropriate, cost-based* blocking structure and charges. It is the OCA's view that Duquesne's load research program does not provide a basis upon which to determine whether flat, inverted, or declining rates are appropriate, based upon the assignment of demand costs. The OCA's position is that Duquesne does not meter a statistically valid sample of individual residential customers and thereby provide a basis for comparison of usage patterns of customers with varying kilowatt-hour usage, but rather merely meters the demand on six test circuits, each serving a number of customers, with a consequent inability to relate individual customers' energy usage to their peak demands. The OCA requested that Duquesne be directed to "perform load research that will allow this commission to properly consider this issue."

The OCA excepts to the ALJ's omission of any discussion of this subject in his recommended decision, stating that the issue had been presented in its *reply* brief. The OCA's exception is essentially a paraphrased repetition of what was stated in its reply brief.

We have previously commented upon the inappropriateness of a party first raising an issue in reply brief. In our opinion and order in the last Duquesne proceeding at R-811470, April 19, 1982, we stated:

"PAJE [Pennsylvania Alliance for Jobs and Energy] proposed for the first time in its reply brief that the amount of $529,202 (total company), which represents

customer deposits, be deducted from rate base. The reply brief of a complainant is a singularly inappropriate place for an adjustment to be first proposed, at a time at which the commission will be denied the benefit of the utility's response. But for the fact that we find other difficulties which we will set forth herein, we would reject the proposed adjustment out of hand, for untimeliness." Id at 14.

But for the fact that Duquesne anticipatorily addressed the subject in its main brief, for which we commend it, we would have no choice but to refuse to address the issue because of the untimeliness of the OCA in addressing the subject for the first time in its reply brief.

Turning to the merits of the OCA's request, we are uninformed regarding the anticipated cost of a metering program such as suggested by the OCA witness. We would speculate, based upon our recollection of the costs for other utilities, that such costs would be in the neighborhood of $500,000 to $1 million for an initial one-year program.

Without going into a detailed analysis, based upon the record before us, we are not satisfied, that a new or expanded residential metering program by Duquesne is either necessary or appropriate. We reject the OCA's request and its exception is denied.

C. *Conservation Program*

The OCA presented a witness, Neil H. Talbot, who presented testimony amounting to a critique of Duquesne's existing conservation programs, and his suggestion for a new and/or expanded program. Mr. Talbot's prepared testimony, OCA Statement No. 4, runs to 70 pages. The ALJ devoted some 13 pages to

the summarization of this issue in his recommended decision, but made no recommendation on the subject. The OCA devotes ten pages in its main brief to the subject, concluding with the injunction that the company's conservation program be expanded into the five programs which it proposed. These were:

1. A more effective residential conservation service program;

2. A refrigerator efficiency rebate program;

3. An air conditioner efficiency rebate program;

4. A wrap-up/turn-down program for water heaters and a seal-up program for dwellings; and,

5. A tariff restriction on electric space heating.[14]

In conjunction with our investigation at I-80100341, we issued an order on August 27, 1982, directing that an investigation be opened for purposes of developing a commission policy, applicable to all electric utilities, whereby regulatory incentives would be afforded to any cost-effective conservation-inducing investment designed to lower a utility's need to install additional capacity.

On September 21, 1982, we issued an order, with an attached proposed policy statement on regulatory treatment of conservation and load management programs, which we directed be published in the *Pennsylvania Bulletin* and served upon all Class A electric utilities subject to regulation by this commission, the Office of Consumer Advocate, and the Governor's Energy Council. All Class A electric utilities were directed to submit comments thereon and all other interested parties were invited to submit comments.

[14]The reader is referred to pp. 58-72 of the ALJ's recommended decision for a detailed summary of these programs.

In light of the ongoing generic investigation we deem it wise to await the outcome of that investigation prior to the adoption of any specific program for a particular utility. Consequently, the OCA's request and its exception is denied.

VIII. *Conclusion*

We have concluded herein that Duquesne is entitled to an opportunity to earn income available for return of $207,112,000 based upon its Pennsylvania jurisdictional operations. This constitutes an increase in operating revenues of approximately $105,850,000 or approximately 64 per cent of the $165 million increase requested. In furtherance of such an objective Duquesne is authorized to establish rates which will produce $802,463,063, annually, in total Pennsylvania jurisdictional operating revenues, in such a manner as is more fully described in the appropriate ordering paragraphs.

SHANAMAN, chairman, dissenting: On April 30, 1982, Duquesne Light Company filed for an electric revenue increase of $165,013,000 annually which represents an increase of approximately 20 per cent.

It should be noted that the company's most recent increase of $64.2 million was finally approved less than one year ago, on April 15, 1982.

I believe the commission's final order, which will allow additional revenues of approximately $105 million, erroneously permits the full recovery of the company's costs associated with canceled CAPCO units, allows the unwarranted expansion of the commission's test-year concept, permits a generous return for the company's shareholders, and fails to flow through the benefits of state income tax deductions to the company's ratepayers. For these reasons, I must dissent.

The commission's decision to permit full cost recovery of the company's investment in four canceled nuclear units is a reversal of established commission policy concerning generating plants which are not considered used and useful. In a 1979 Philadelphia Electric Company case (RID 438) we stated:

"The fact that excessive plant investments were prudent when made does not necessarily preclude the commission from alloting responsibility for their cost."

By permitting full recovery of all costs, the commission has also disregarded the expert opinion of its own trial staff. Trial staff was on target when it stated:

"The courts in this jurisdiction, however, make it clear that public utilities are entitled to a fair return on the fair value of property used and useful in providing service to the public and that only the costs of such used and useful property may be included in rates. The costs of property that never provided service to the public, regardless of prudence, must be excluded from customer rates."

By insulating management from all business risks (while permitting a premium equity return) we are not equitably balancing the interests of ratepayers and stockholders.

The commission has informally considered proposals to expand the current test-year concept to include all expenditures made during the first year rates are in effect. Fortunately, these attempts to expand the future test-year concept have failed. The commission acceptance of *estimated* expenditures for environmental control projects *expected* to be in service during 1983 again violate the principle of allowing only used and useful property in rates. The allowance is based upon com-

pany estimates and expectations which may, in fact, prove to be inaccurate. Any overestimate of costs will be fully assumed by ratepayers, however, thus once again shifting risk from the shareholder to the ratepayer.

Nowhere is the commission's failure to balance the interest of the investor and ratepayer more obvious than in its treatment of state tax reductions. Despite the fact that the company is not required by law to retain use of these funds, the commission concludes that normalization of these taxes "should improve its (the company's) financial position with attendant benefits, not only to investors, but to its customers as well" (Pennsylvania Power Company, R-811510). I suspect that most customers, many of whom are finding it hard to survive in a recessionary economy with high unemployment, would find little solace in the commission's logic. The commission's action is analogous to demanding that hard-pressed ratepayers (many of whom are unemployed) advance a $6 million loan to the company simply to improve its cash flow. If this "loan" is ever repayed by the company, it will be in the form of future dollars which will have lost much of their value due to inflation. Ironically, this improved cash flow comes at the expense of consumers who have a greater need for cash than does the company. Where normalization is required by law it is defensible; the case at hand provides absolutely no justification for such an action.

Despite shifting the risk in several key areas from the company to the ratepayer, the commission would give the company's stockholders an opportunity to earn a return in excess of 16 per cent on their investment. What must be kept in mind is that most interest rates for long-term debt have fallen nearly 5 per cent in the past

year. The prime rate, which was 15.75 per cent one year ago, is now 11 per cent. Thirty-year Treasury bonds, which were at 14.30 per cent, are now 10.6 per cent. Based upon historical trends as well as data contained on the record, the trial staff recommended allowance of 15.8 per cent is quite generous.

Regulation must, by definition, be protective in character. Regulators have a three-fold responsibility; the needs of consumers, investors, and the communities served by the utilities must be balanced. I believe my positions maintain that balance. In times such as these, it is not unreasonable to expect stockholders to assume some of the costs of canceled nuclear units. It is also not unreasonable to flow through tax benefits to the hard-pressed Pittsburgh consumer. These actions, while protecting ratepayers, would still provide the company with the funds necessary to permit investors a reasonable return on that part of their investment serving a public need and to preserve the financial health of the company.

JOHNSON, commission, dissenting: The majority opinion in this proceeding is unjust and unreasonable and does not produce a just and reasonable result.

Construction Work in Progress

The majority's post-test-year recognition of construction work in progress is based on the commission opinion in Pennsylvania Pub. Utility Commission v Philadelphia Electric Co., R-811626. I objected to that opinion, and filed a dissenting opinion. I similarly object to post-future test-year budget projections in this proceeding as the basis for part of the increase in this proceeding.

Cash Working Capital

Inasmuch as the post-test-year nuclear fuel reload scheduled for early 1983 is another out-of-period

speculative adjustment I object to the inclusion in the rate base of $5,848,344 for this purpose and note that I also objected to this matter in the Philadelphia Electric Company case cited above.

As a general proposition I have found that the *actual necessity* for working capital, supplied by investors, in a going concern utility is an illusion.

A demonstration that receipt of revenues lags behind the payment of expenses does not per se demonstrate the actual necessity of the condition which fluctuates both within and among utilities. It is abundantly clear from the rate proceedings before the commission that the utility-proffered analyses do not reflect all available ratepayer-provided sources of working capital such as accrued but unpaid taxes, accrued but unpaid interest on outstanding debt, and accrued but unpaid dividends on preferred stock.

The existence of a lag does not demonstrate the reasonableness of: the terms under which a utility conducts transactions with affiliates; the calculation of payroll lags; the lag in the payment of bills rendered by vendors; the time required to render a bill to its customers at the conclusion of a billing cycle; the time required to post transactions on the company records when payments are made and received; the length of the billing cycles; the credit and collection policies.

There is some sentiment on the commission that the time and effort spent on this subject has been out of proportion to the impact of working capital on rates. I would point out that the time and effort spent by the commission has produced such a wide variety of results that I can hardly believe that the efforts as they are should be continued. But neither can the company claims be accepted.

According to the quarterly reports submitted to the commission the following spectrum of "expense days" have been included in the rates of the major utilities.

	Expense Days		*Expense Days*
Met Ed	zero	Columbia	12.6
Penelec	3.3	Equitable	3.0
West Penn	4.1	National Fuel	2.0
Duquesne Light	17.9	North Penn	20.5
PP&L	22.9	Pa. G&W	5.1
UGI (el.)	30.3	Peoples	5.3
PE Co. (el.)	39.6	PE Co. (gas)	18.3
Pa. Power	59.3	UGI (gas)	14.5

Management policies directly affect working capital and must be considered when arriving at conclusions as to the reasonableness of a particular claim.

Sales to Crucible Steel

I do *not* dissent from the resolution of this issue by the majority. I have chosen to comment here in full support of the language used by the commission in the hope that it was not unintentionally included. I specifically and expressly support the following proposition:

"In examining Duquesne's adjustment methodology, as constrasted [sic] with that of the staff, we find nothing to commend it over the staff's methodology, insofar as validity is concerned, and therefore conclude that Duquesne has failed to meet its burden of proof concerned in this adjustment."

Rate Case Expense

No reason has been provided which has not been previously considered and rejected by this commission for a change from a ten-year amortization to a five-year amortization. I therefore object to the reconsideration of the commission's prior decision on this matter.

Moreover I maintain the strong view that rate case expense is uniquely an expression of the risk which justifies various considerations extended to investment capital. Therefore to again make ratepayers responsible for such expenses and exonerating investors serves only to make a nullity of the creditability of the investors' claim for a reward for risk.

Cost of Terminating Four Nuclear Generating Units by CAPCO

Two separate recommendations pertained to the resolution of the issues:

(1) ALJ-3 by Judge Matuschak docket I-79070315 and I-79070317

(2) ALJ-9 by Judge Klovekorn docket R-821945

Judge Matuschak issued a report terminating the investigations, and allowing Duquesne Light and Penn Power to amortize their respective portions of the cancellation costs relating to Davis-Besse Nos. 2 and 3 and Erie Nos. 1 and 2, in appropriate rate cases in such amount as therein determined over a period of ten years with no return on the unamortized portion thereof.

Judge Klovekorn noted that Judge Matuschak's report had not been reviewed by the commission in time for inclusion in the final recommendation in the rate case.

The Duquesne Light Company has made a revised claim for $3,469,739 per year for a ten-year period, and has made similar claims in each of its two prior rate cases. Each claim has been rejected pending the outcome of the GAPCO investigation at I-79070315.

The claim is opposed by the trial staff, the consumer advocate, PAJE, and four commercial complainants

(Equitable Life Assurance Society of the United States, Joseph Horne Company, Kaufmann's, and Gimbels), in total and in varying levels of detail.

Despite the fact that *thousands* of pages of text have been dedicated to this issue I will be brief.

1. Philadelphia Suburban Water Co. v Pennsylvania Pub. Utility Commission (1981) 58 Cmwlth 272, 427 A2d 1244: If extraordinary gains on disposal of property not in rate base is not creditable to ratepayers, neither may ratepayers be charged with extraordinary losses on such property. There being no legal basis in Pennsylvania law for the charging of extraordinary losses to ratepayers the claim might be dismissed as a matter of law. However:

2. UGI Corp. v Pennsylvania Pub. Utility Commission (1980) 49 Pa Cmwlth 69, 410 A2d 923: "A public utility is entitled to recover all of its reasonably incurred expenses. The feasibility studies here in question were a direct and clearly prudent step in providing public service and UGI is entitled to recover their cost."

Considering these two Pennsylvania cases together it appears that Duquesne would be entitled to recovery for expense but not property; nor would they be entitled to a return on nonused and useful property.

From this I conclude that:

1. The issue must be remanded to one of the two ALJ's to complete the record.

2. Allowance for funds used during construction included in the claim is merely prior earnings that were capitalized and therefore should not be a part of the claim if no allowance for return on investment is intended.

3. Expenses must be segregated from property so that expenses might be recognized, in particular the site cost, if it is a part of the claim, clearly cannot be passed on to ratepayers under the Philadelphia Suburban Water Company case.

4. The parties to the remand should address the implementation of any recovery either through rates or as credit against a refund or some other appropriate means.

5. No allowance should be made in either the investigation or the rate case.

The very same plants and their related cancellation costs were considered by the public utility commission of Ohio. The Ohio commission, like the majority there, decided to pass the costs through to the ratepayer, making the ratepayer liable for the cancellation of the projects that never would be used or useful. The matter was appealed to the Ohio state supreme court by consumer groups. The Ohio state supreme court overturned the Ohio commission. The utilities then took the Ohio state supreme court decision to the U.S. Supreme Court which refused to review the state supreme court decision. Recently, the U.S. Supreme Court refused to hear the utilities' complaint against the Ohio commission's order reducing rates as a result of these developments.

It seems to me, no matter how different the minor details may be, that having the U.S. Supreme Court refuse to disturb the Ohio state supreme court decision disallowing this kind of a passthrough, requires a little more than a passing glance and explanation.

What the company sought, there and here, and what the commission granted was the amortization as service-

related costs of an investment that never provided any service whatsoever to the utility's customers.

The supreme court of Ohio stated the problem clearly as follows:

"If, as has been argued, these are parlous times for the utilities industry, and if, therefore, in order to attract and retain investment capital, utility companies must not only be granted a fair and reasonable rate of return pursuant to statute but must also be assured the return of capital invested in failed projects that would otherwise not be recoverable under the rate-making formula, then the commission and the utilities should petition the general assembly to enact changes in the rate-making structure so as to provide this extra modicum of protection for the investors. Absent such explicit statutory authorization, however, the commission may not benefit the investors by guaranteeing the full return of their capital at the expense of the ratepayers. Under the rate-making formula now in effect consumers are not chargeable for utility investments and expenditures that are neither included in the rate base nor properly categorized as costs. What we previously stated in a rate base case is applicable to the case at bar: . . . It is only proper that their [the investors] venture be found operational before they commence to recoup their capital outlays from the consumers." Office of Consumers' Counsel v Ohio Pub. Utilities Commission (1979) 58 Ohio St 2d 449, 456, 457, 391 NE2d 311. Ohio, 423 NE2d 820.

I therefore dissent from the recognition in rates of the entire amount claimed toward amortization of the costs of cancellation.

EPRI Dues

The EPRI dues claim is based on anticipated 1983 payments and is clearly outside the future test year and should not have been accepted.

Emergency Energy Surcharge

Inasmuch as the majority relies on Pennsylvania Pub. Utility Commission v West Penn Power Co. (1981) 54 Pa PUC 602, from which I dissented; and because there has been at least one other Duquesne Light rate case begun and closed (R-811470) establishing commission made just and reasonable rates since our decision in West Penn, and because this is a recovery of an extraordinary expense which occurred four years before the test year in this case I object to its allowance here. Furthermore West Penn's claim was adjusted by the commission to reflect only the period after which the surcharge was authorized and certain other offsetting adjustments were adopted which are not apparent here.

RCS Program Expenses

The company is claiming $2,400 for one-year amortization of program start-up costs, $13,000 for one-year amortization of deferred 1981 recurring program costs, and $100,000 for 1982 test-year recurring program costs.

It appears that the $2,400 ($12,031 ÷ 5) nonrecurring start-up costs have been properly recognized and amortized according to Pa Code § 69.73(b).

The company is requesting that the unrecovered 1981 recurring program expense ($64,994) also be amortized over five years. We allowed UGI-Gas to amortize the expenses over two years. Five years is better than two.

The $100,000 test-year recurring program costs are high. Based on my estimates of participation, this amounts to $517 per audit. These high per audit costs are *partially* due to the fact that the company is required to provide program announcements to all of its residential customers while only its electric and oil heating customers are likely to participate in Duquesne's program. Excluding program announcements costs, audits will cost $212 to perform. This may be reasonable considering the very poor economy of scale that the company may be realizing as a result of low participation; i.e., less than four audits per week.

Considering the amount of money involved I support the majority and the company.

The Majority Failed to Amortize Nonrecurring Maintenance Expenses

Trial staff witness Jones testified that the 1982 budgeted amounts for Account 513 and Account 552 should be adjusted downward since the budgeted amounts were a continuation of the 1981 level which included major maintenance work of a nonrecurring nature. The majority rejected the proposed adjustments based upon the view that the analysis of maintenance expenses should be conducted in the context of the company's entire maintenance program. This approach, however, would substantially limit the ability of the commission to examine the reasonableness of Duquesne's future test-year claims.

The test-year data in this rate case is based on the 1982 budget. If this commission were to accept the 1982 budget as the basis for allowable operating expenses simply because the amounts approximate 1981 expense levels, the ability to detect unusual nonrecurring ex-

penses or unreasonable expenses would be completely eliminated. Thus, overstated or unusual 1981 expenses would be built in to the 1982 allowable operating expenses.

With respect to Account 513, the record demonstrates that $2 million of the $2.6 million increase in the 1981 expense level can be accounted for by the major maintenance work that was done at the Cheswick plant. The 1982 budget simply carries forward the 1981 expense level. Based on a five-year amortization of the major maintenance work at Cheswick, 1982 budgeted Account 513 maintenance expenses should be reduced by $1,570,191.

With respect to Account 552, the record demonstrates that $300,000 of the increase in the 1982 budgeted amount was due to the painting project at the company's Brunot Island plant, last performed eight years ago. Based on an eight-year amortization of the painting project costs, 1982 budgeted Account 552 maintenance expenses should be reduced by $262,500.

Normalization of State Taxes

The Pennsylvania Power Company case cited by the majority opinion is in fact the case on which the majority relies. The other cases cited merely refer to the conclusion reached in the Pennsylvania Power case. Much time and effort was expended by the consumer advocate in litigating the issues of law and policy in that case. I found the OCA efforts to produce the correct conclusion and dissented from the majority opinion. That case is on appeal and I am not persuaded that normalization of state income taxes makes sound policy. Nor am I pursuaded that normalization of state income taxes is authorized in Pennsylvania law. I therefore dissent from the resolution of this issue as well.

APPENDIX D

Order of the Pennsylvania Public Utility Commission Upon Reconsideration (Duquesne Light Co.)

Pennsylvania Public Utility Commission

v

Duquesne Light Company

R-821945 et al. I-79070315

April 15, 1983

PETITION for reconsideration of allowance of amortization of canceled plant investment and rejection of conservation plan; granted in part and denied in part. For earlier decision, see (1982) 51 PUR4th 198.

By the COMMISSION:

Opinion and Order
Upon Reconsideration

On February 14, 1982, the Office of Consumer Advocate (OCA) filed a petition for reconsideration and modification of our opinion and order, herein, of January 28, 1983 (51 PUR4th 198). The petition sought reconsideration and modification with regard to two issues; namely:

1. The allowance of the amortization of the investment in certain canceled generating plants; and,

2. The rejection of the OCA's proposed conservation plan.

Additionally, the petition sought clarification of the language and import of the opinion and order, so that nothing contained therein might be construed as approval or endorsement of the continuing CAPCO construction program.

On February 25, 1983, Duquesne Light Company filed its answer. Answers have not been filed by any other party to the proceedings. However, by letter filed February 22, 1983, the commercial complainants stated that they joined with the OCA insofar as its petition seeks reconsideration of the allowance of the amortiza-

tion of Duquesne's investment in the canceled generating plants.

Preliminary Matters

In its answer and opposition to the OCA's petition, Duquesne has asserted that the opinion and order of January 13, 1983, at I-79070315, is not subject to challenge. Duquesne has variously said in this regard, that: "the commission's final order at I-79070315 was entered on January 13, 1983, and as no petition for review was timely filed with respect thereto, that order is *no longer subject to* challenge" (emphasis in original); "the consumer advocate having failed to appeal the January 13, 1983, order is estopped from challenging the propriety of its findings at this date"; and, "as heretofore noted the commission's January 13, 1983, order at I-79070315 is final and may not be attacked by any party to that investigation." While it is true that the time for filing a petition for review with the commonwealth court has run, such assertions are directed to us and we interpret them as urging upon us the position that there is some legal impediment to our consideration of the OCA's petition. However, Duquesne has not explained the exact nature of that claimed impediment. If Duquesne's position is that a petition for reconsideration must be filed with the commission within the time prescribed for a petition for review with commonwealth court, it is incorrect. The applicable commission rule of practice and procedure, appears at 52 Pa Code § 3.291. That rule does not prescribe a time within which a petition for reconsideration must be filed and by its own terms supersedes the provisions of 1 Pa Code § 35.241, which prescribes a 15-day period for such petitions. Consequently, we reject Duquesne's various assertions that the OCA's petition is untimely.

Duquesne also makes reference to our comments in our opinion and order of January 7, 1983, in Duick v Pennsylvania Gas & Water Co. (1982) 51 PUR4th 284, regarding petitions for reconsideration, which was that such a petition, under the provisions of 66 Pa.C.S. § 703(g), "may properly raise any matter designed to convince the commission that it should exercise its discretion under this code section to rescind or amend a prior order." (51 PUR4th at p. 289.) It was further said there that what "we expect to see raised in such petitions are new and novel arguments, not previously heard, or considerations which appear to have been overlooked or not addressed" (51 PUR4th at p. 289), and that parties will not be permitted by a second pleading to raise the same questions which were specifically considered and decided against them. Duquesne urges that the OCA petition be judged by the enunciated criteria. We agree and the enunciated criteria will be applied.

Background

On January 25, 1983, we issued an opinion and order in the above captioned proceeding which, in pertinent part, permitted the amortization of $3,469,739 per year (for a contemplated ten years) of Duquesne's investment in four canceled nuclear generating units, namely Davis Besse Unit Nos. 2 and 3 and Erie Unit Nos. 1 and 2, the stated amount being allowed as an operating expense; and, denied the request of the OCA that Duquesne be required to implement the OCA's proposed multifaceted conservation plan.

The investigation at I-79070315, into the delays in the OCA's continuation program was initiated by commission order of July 27, 1979. In pertinent part, that order stated that:

"In November, 1978, CAPCO[1] announced major delays in the construction schedules of seven large electric generating units ranging from sixteen to thirty-six months.

"The extended schedule of construction will increase the cost of these generating units through inflation and through an increased allowance for funds used during construction (AFUDC). Further, energy costs will probably be higher as these new baseload units will not be on line to serve the consumers' needs.

"We believe that the problems presented by these construction delays merit the commission's consideration; therefore,

"It is ordered:

"1. That a formal investigation is hereby instituted to determine the impact of the CAPCO construction costs upon the rates charged, and the service provided by Duquesne Light Company."

In response to petitions for modification and reconsideration of the July 27, 1979, order, the commission's November 8, 1979, order, clarified the scope of the investigation as follows:

"A thorough evaluation of delays in construction schedules must include an investigation of Duquesne's (Penn Power's) load forecasts, the load forecasts for the CAPCO system as a whole. A thorough evaluation of the best solution to construction delays must include the options of stepping up the schedules of plants under construction, delaying initiation of additional construction, halting construction on some plants, or investing in small other fuel plants. Each option must be con-

[1]CAPCO stands for the Central Area Power Coordinating Group.

sidered and evaluated in terms of its ultimate impact on Duquesne's (or Penn Power's) customers."

By separate order of July 27, 1979, at I-79070316, the commission instituted an investigation into customer conservation incentives, including demand metering. In pertinent part, that order stated:

"Energy conservation is a key concern of this commission and the nation. Not only is it imperative that we get the most out of each Btu and kilowatt-hour, but that we also use each kilowatt of installed capacity most efficiently.

"Over the past several months we have witnessed oil shortages, escalating fuel costs, nuclear outages, and strict environmental regulations on generating stations. We must have conservation. The best way to voluntarily induce effective conservation is through economic incentives.

"It is our belief that Duquesne Light Company should undertake an agressive [sic] imaginative program designed to encourage conservation in order to reduce the costs of providing service; therefore,

"It is ordered:

"1. That within thirty days of entry of this order, Duquesne Light Company shall submit to this commission a conservation plan including, but not limited to the following actions:

"(a) the use of newspaper advertisements and bill stuffers to inform their ratepayers of the need to conserve electricity,

"(b) the negotiation with ratepayers who have standby, emergency or self-generation facilities to make substantial use of such generation, where cost effective,

"(c) the implementation of voluntary load curtailment pursuant to emergency fuel conservation tariff procedures filed in compliance with the commission's order at Emergency Regulation Docket No. 3,

"(d) the implementation of a credit billing system which rewards conservation through a credit per kilowatt-hour and reduces the bills of ratepayers who achieve at least 5 per cent conservation, determined from past consumption in like periods, and thereby lessens the need for purchases of high cost energy,

"(e) the proposed implementation of curtailment and conservation procedures for commercial and industrial ratepayers shall be accompanied by specific proposals to encourage such conservation through the elimination of 'ratchet' or historic demand charges and minimum bills for those ratepayers who do conserve and through the incremental pricing of usage in excess of the targeted conservation consumption for those ratepayers who do not conserve.

"2. That within sixty days of the date of this order, Duquesne Light Company shall submit a plan to this commission for the implementation of a demand-metered rate for residential customers and a plan for converting residential customers to demand meters. A detailed benefit-cost analysis of this proposal must accompany the plan."

On August 10, 1979, Duquesne filed a petition for termination of the investigation and a petition for extension of filing deadline. By order entered October 22, 1979, the commission denied the petition for termination of investigation, but granted the petition for extension of filing deadline. On November 19, 1979, the revised energy conservation plan was filed with the commission.

On January 29, 1980, the trial staff, noting the filing of the conservation plan, requested that the docket be closed. The company joined in the request. On February 21, 1980, the OCA filed a motion to consolidate the CAPCO investigation with the conservation investigation. Both requests were effectively denied by the commission's order of June 11, 1980, initiating an investigation into the company's general rate increase application at R-80011069, which consolidated the proceedings at I-79070316 with the proceedings at R-80011069.

On February 20, 1981, we entered an opinion and order in the consolidated proceedings, wherein it was concluded that the areas of investigation specified in the order of July 12, 1979, at I-79070316 had not been adequately addressed. Consequently, the investigation was not addressed in that opinion and order, and it was provided that the investigation remain open until further order.

On April 30, 1981, Duquesne filed a general rate increase application which was docketed at R-811470. That proceeding, after acceptance by Duquesne of an option order by filing revised tariffs on June 30, 1981, which tariffs were accepted on July 17, 1981, proceeded to hearing. The proceedings were terminated by our opinion and order of April 19, 1982, which found the rates contained in the option order tariff filing of June 30, 1981, accepted July 17, 1981, were just and reasonable.

On April 30, 1982, Duquesne filed the instant application for a general rate increase, docketed at R-821945. This proceeding was terminated by our opinion and order of January 28, 1983 (51 PUR4th 198), which granted approximately $106 million of the requested increase of approximately $165 million. Included in the

operating expenses found reasonable were $3,469,739 which represented one year's recovery of a ten-year amortization of the Duquesne investment in the four canceled CAPCO nuclear generating units, the unamortized balance of which was excluded from rate base. Additionally, that opinion and order declined to adopt the OCA's proposed five-point conservation plan for Duquesne, deferring any decision regarding any expanded conservation plan for Duquesne, until the conclusion of the generic investigation into a proposed policy position regarding regulatory treatment of conservation and load management programs, at I-801-00341 (49 PUR4th 165).

Requested Clarification

In its petition the OCA claims that the ALJ's recommended decision contains a number of erroneous conclusions. The OCA then requests that, in light of ALJ's conclusions with which it takes specific issue and other unidentified errors, our opinion and order of January 28, 1983, "be modified so that it shall not be construed as an endorsement of the continuing CAPCO construction program."

In its answer, Duquesne, has first asserted that the OCA, having failed to appeal the order of January 13, 1983, at I-79170315, is estopped from challenging the propriety of the findings at this time. We disagree with this conclusion because unlike the rules of appellate procedure, there is no time limit placed upon a petition for reconsideration under our rules of practice and procedure. Duquesne then quotes the ALJ's conclusion at p. 74 of his report of investigation:

"That the CAPCO program for the completion of the construction of Perry No. 1 and No. 2 and Beaver

Valley No. 2 is the reasonable and prudent course of action, and that Dr. Rosen's recommendations must be rejected."

Duquesne states that the ALJ's conclusion is fully supported by the evidence, and that "the commission has adopted this finding as its own."

In light of the conclusion stated by Duquesne it appears necessary that we clarify the import of our order of January 13, 1983, and our opinion and order of January 28, 1983. Perhaps the order of January 13, 1983, more appropriately, should have stated that we accepted or approved the ALJ's report of investigation, for it was our intention to only specifically endorse those conclusions contained therein which were necessary antecedents to the action taken, which was to allow the amortization of the costs incurred, with regard to the canceled generating plants, over a ten-year period. This action only required a decision on our part as to two essential matters. First, that the initial decisions by Duquesne and the Pennsylvania Power Company to participate in the ownership of these four generating plants was prudent at the time at which it was made. Second, that the decisions to delay cancellation until 1980, when that decision was made, were prudent. Stated in another manner, we conclude that the interim decisions regarding the four generating plants were prudent.

Since any conclusions expressed by the ALJ on any other subject or matter addressed in his report of investigation are not necessary antecedents to our action, our action does not constitute an endorsement or adoption of those conclusions.

With regard to our opinion and order of January 28, 1983, we stated that we had adopted ALJ Matuschak's

report of investigation. While we might more appropriately have said that we "approved" that report, we went on to characterize the effect of that action as a passing upon "the merits of Duquesne's request to amortize their cancellation costs . . . over a period of ten years, with no return on the unamortized balance thereof." (51 PUR4th at p. 218.)

With this clarification provided we do not believe that there should be any misconception that our order of January 13, 1983, or our opinion and order of January 28, 1983, constitute an endorsement of the continuation of the construction on Perry No. 1 and No. 2 and Beaver Valley No. 2 either prospectively or for any past period. Our actions constitute no comment upon either past or current decisions with regard to these three generating units.

CAPCO Cancellation Costs

In its petition the OCA calls our attention to Senate Bill 1366 which became Act 335 on December 30, 1982, with an immediate effective date. This act adds § 1315 to 66 Pa CS, and the bill as enacted is as follows:

"*Section 1.* Title 66, Act of November 25, 1970 (PL 707, No. 230), known as the Pennsylvania Consolidated Statutes, is amended by adding a section to read:

"Section 1315. Limitation on consideration of Certain Costs for Electric Utilities.

"Except for such nonrevenue-producing, nonexpense-reducing investments as may be reasonably shown to be necessary to improve environmental conditions at existing facilities or improve safety at existing facilities or as may be required to convert facilities to the utilization of coal, the cost of construction or expansion of a facility

undertaken by a public utility producing, generating, transmitting, distributing, or furnishing electricity shall not be made a part of the rate base nor otherwise included in the rates charged by the electric utility until such time as the facility is used and useful in service to the public. Except as stated in this section, no electric utility property shall be deemed used and useful until it is presently providing actual utility service to the customers.

"*Section 2.* This act shall be applicable to all proceedings pending before the public utility commission and the courts at this time. Nothing contained in this act shall be construed to modify or change existing law with regard to rate-making treatment of investment in facilities of fixed utilities other than electric utilities.

"*Section 3.* This act shall take effect immediately. Act amending Title 66 (Public Utilities) of the Pa.C.S., No. 335, December 30, 1982 (to be codified at 66 Pa.C.S. § 1315)."

The OCA states its conclusion that Duquesne's recovery of its investment in the canceled generating plants is precluded by the quoted recent legislature enactment "in that it allows the inclusion in rates of the cost of construction of an electric utility facility which is not presently providing and, in fact, will never provide actual utility service to its customers." The OCA does not continue and provide any argument or reasoning in support of its stated conclusion.

Duquesne has responded to the OCA's stated conclusion and urges that the OCA's conclusion is contrary to the intent of the legislature in adopting the act.

In reviewing the act we find that in general terms it provides that, except for nonrevenue-producings, non-

expense-reducing investments in facilities to improve environmental conditions or safety at existing facilities or as may be required to convert facilities to coal, the costs of construction or expansion of a facility shall not be included in rate base *nor otherwise included in the rates charged* until the facility is used and useful, which is defined as presently providing actual utility service. The proscription of the act is in accord with historic commission regulatory practice regarding electric utilities. The OCA's claimed impediment appears to rely upon the words "nor otherwise included in the rates charged by the electric utility" to support its position, implicitly claiming that the amortization of costs incurred prior to cancellation of the plants (as an alternative to depreciation since there is no depreciable property) is a prohibited inclusion of the costs of construction in rates. In our view the quoted portion of the act is not entirely clear and to our knowledge there is no regulatory practice or utility-proposed regulatory treatment as an alternative to inclusion in rate base, which this disjunctive phrase is designed to prevent. Consequently, to our reading the quote disjunctive prohibition is merely designed to prohibit both the inclusion of construction work in progress in rate base and any alternative rate-making action, which some inventive mind might create, as an alternative which would accomplish the same or similar result. In attempting to ascertain the intent of legislation 1 Pa.C.S. § 1921(c) lists some eight matters which may be considered. Among these is the "object to be obtained." In this regard the language of the act is in complete accord with the historic commission practice with regard to regulatory treatment accorded to construction work in progress rate base claims, and in this respect we view the act as both a legislative endorsement of historic commission practice

and a mandate to continue that practice, rather than an enactment to achieve some different objective. In similar view, with regard to the consideration of the "mischief to be remedied" we perceive that there was no existing mischief or regulatory practice which the act was designed to remedy, but rather that the enactment was designed to prohibit any possible change to an unacceptable practice.

The last of the enumerated considerations which we believe are pertinent here is that of the "consequences of a particular practice." Were we to accord to the phrase in question, the very literal interpretation which the OCA seemingly urges, any construction expenditure for a facility not used and useful, that is presently providing "actual utility service," could neither be included in rate base or recognized in any manner in rates. This very literal interpretation would exclude rate base recognition or the fair rental expense recognition of a utility office building because it would never be utilized in providing "actual utility service." Similarly, any other structure not utilized in the generation, transmission, and distribution of service could neither be included in rate base or recognized on a fair rental expense basis.[2]

A similar very literal interpretation would also preclude the recovery of unrecovered investment in prematurely retired utility plant (since such plant would no longer be used and useful), the recovery of which is clearly contemplated and provided for in the Uniform System of Accounts for electric utilities and which is the regulatory treatment which this commission has accorded to such unrecovered investment in appropriate

[2]Pa.C.S. § 1921(1) also provides "[t]hat the general assembly does not intend a result that is absurd, impossible of execution or unreasonable."

instances in the past. We do not perceive any legislative intent to prohibit this regulatory practice.

In its answer, Duquesne has pointed out an additional consequence of the OCA's very strict interpretation of the act, which is that a utility would be prompted to continue with construction to completion in order that rate base inclusion be accorded to such plant even though the most reasonable economic decision would be to terminate construction. Duquesne also raises an issue as to the constitutionality of the act, if, based upon a strict interpretation of the act, it is precluded from recovery of a prudently incurred capital expenditure. While we will not undertake to resolve this issue, we do believe that this issue of constitutionality is real and not fanciful.

Having considered the matters discussed above we are led to the conclusion that the legislature did not intend that the act be interpreted in the manner urged by the OCA but rather it was an endorsement of past commission regulatory treatment of construction work in progress and a prescription of the continuation of that practice. Viewed in this light, the troublesome phrase of "nor otherwise included in the rates charged by the electric utility" merely precludes some alternative regulatory treatment to inclusion in rate base, designed to circumvent the letter of the act and achieve the same or similar result to that achieved by rate base inclusion and not a prohibition of the recovery of prudent investment in a plant which is prematurely retired or one which is canceled by reason of a change in economic circumstances. We conclude, therefore, that the OCA's objection is not well taken and our approval of amortization of the investment in the four canceled generating plants does not contravene the act and accordingly, its request that such costs be disallowed is denied.

Conservation Program

Initially the OCA notes: (1) that in our opinion and order of January 28, 1983, we decline to adopt and mandate its proposed five-element conservation program for Duquesne, stating that in light of the existence of the current generic investigation we deemed it wise to await the outcome of that investigation prior to mandating any additional conservation action for Duquesne; (2) that our order adopted September 17, 1982, initiating that investigation stated that "this investigation should not impede the progress of any conservation or load management effort being undertaken by any utility"; and, (3) that Duquesne has presented testimony in the CAPCO proceeding that it believes that it will be deficient in capacity in the late 1980s or early 1990s and be marginal in the mid-1980s.

The OCA then asserts that for both the purposes of reliability and economy, "Duquesne's ratepayers are entitled to immediate implementation of any and all cost-effective conservation measures" and that "[r]egardless of the arguments as to the merits of individual line items in the OCA's five-point program, there can be no reasonable doubt that, based on the record in this proceeding, a substantially more extensive program than the informational program now in place is cost effective for this utility which has the second highest rates in the state."

The OCA concludes with the assertion that failure to order a cost-effective program is a violation of our statutory mandate pursuant to §§ 1301, 1501, and 308 of the Public Utility Code.

We disagree with the conclusion of the OCA that our action in rejecting its proposal to mandate its five-point

conservation program is violative of our duties under the Public Utility Code. Further, the OCA's comments and assertions have not convinced us that our rejection of its proposed conservation program was unwise. Our desire to await the outcome of the generic investigation before mandating addition[al] actions by Duquesne does not, as we said, impede any actions which it might wish to undertake, and we believe that the end result which will be forthcoming from the generic investigation, has a much greater likelihood of being an effective, comprehensive approach to both conservation and the abatement of load growth, than does any program which would be adopted at this point in time.

Conclusion

Having fully reconsidered the assertions and arguments of the OCA we are not satisfied that our decisions on the two issues of: (1) the amortization of Duquesne's investment in the canceled generating plants; and, (2) the rejection of the OCA's proposed five-element conservation plan was either unwise or in error, and, consequently, no modification of our opinion and order of January 28, 1983, is either appropriate or required. As to the matter of the import of our opinion and order of January 28, 1983, and our order of January 13, 1983, as it pertains to the continuation of construction on the remaining three generating plants, we have provided what we believe to be the necessary clarification.

APPENDIX E

Order of the Pennsylvania Public Utility Commission (Pennsylvania Power Co.)

Pennsylvania Public Utility Commission et al.

v

Pennsylvania Power Company

Additional complainants: Office of Consumer Advocate, Sharon Steel Corporation, and Borough of Enon Valley et al.

R-832409 et al.
April 6, 1984

APPLICATION *for authority to increase electric rates; granted as modified; income tax expenses reduced by hypothetical interest deduction associated with unamortized job development investment tax credit.*

Opinion and Order

By the COMMISSION:

I. *Introduction and History of the Case*

On July 13, 1983, Pennsylvania Power Company (Penn Power or the company) filed with the Pennsylvania Public Utility Commission (PUC or the commission) Supplement No. 29 to its Tariff Electric-Pa PUC No. 33 to become effective September 11, 1983. Supplement No. 29 requests an increase in the company's total annual operating revenues of $19,890,200 based upon a future test year ending March 31, 1984.

By order entered August 20, 1983, we instituted a formal investigation (docketed at No. R-832409) to determine the lawfulness, justness, and reasonableness of the proposed rates and of existing rates. Supplement No. 29 was thereby suspended by operation of law for the seven-month period provided under § 1308 of the Public Utility Code (66 Pa.C.S. § 1308), or until April 11, 1984,

and assigned to Administrative Law Judge Allison K. Turner for hearing and the issuance of a recommended decision.

Commission prosecutory staff (staff or trial staff) filed its appearance and has participated fully. A total of four complaints were filed against the proposed rates by the office of Consumer Advocate (OCA or the consumer advocate); Sharon Steel Corporation (Sharon); the borough of Enon Valley; and State Representative Ralph D. Pratt. These complaints were consolidated with the commission's investigation for the purposes of hearing, argument, and disposition. In addition, the city of New Castle submitted a letter protesting the increase during the course of hearings, the letter having been signed by the city council president and four council members.

A prehearing conference was held in Harrisburg on September 20, 1983, before the administrative law judge (ALJ) and, pursuant to commission policy, public input sessions were later held in Sharon and New Castle. In addition, a total of thirteen days of hearings were held in Pittsburgh and Harrisburg between October 12, 1983, and December 14, 1983, producing over 1,400 pages of transcript.

During the course of the hearings, the company submitted 16 written statements prepared by ten witnesses and filed 16 exhibits. The staff presented 12 written statements through eight witnesses and formally designated 20 exhibits; OCA presented four witnesses and submitted numerous exhibits; Sharon submitted two written statements and exhibits through one witness. Sharon's participation has been limited to the basic issue of rate structure, including rate design, cost of service, and attendant revenue adjustments. The other named parties did not participate actively in the hearing or briefing process.

The evidentiary record was closed December 30, 1983. Briefs and reply briefs have been filed by the company and the three active parties. Sharon filed a motion to strike a portion of staff's reply brief which was granted by ALJ Turner.

ALJ Turner's recommended decision was issued for exceptions on February 28, 1984. The ALJ recommended that Penn Power be allowed to file tariffs or tariff supplements to provide annual electric operating revenues of $179,703,000, exclusive of state tax adjustment surcharge revenues and net energy clause revenues. ALJ Turner indicates that this would produce an increase in annual base rate operating revenues of approximately $10,015,000.

Exceptions to the ALJ's recommended decision were filed by Penn Power, staff, OCA, and Sharon. Reply exceptions were filed by the same parties.

On March 15, 1984, staff filed a motion to strike an affidavit submitted by Penn Power which attempted to proffer new evidence in the nature of the percentage increases in management salaries actually granted by the company. We find merit in the arguments presented by staff in support of its motion to strike. Accordingly, the motion to strike is hereby granted.

For the reasons fully discussed within the body of this order, we shall permit Penn Power to file tariffs designed to produce annual electric operating revenues of $184,186,000, exclusive of state tax adjustment surcharge revenues and net energy clause revenues. This

will result in an annual increase in base rate operating revenues of approximately $15,364,000.

II. *Description of the Company*

ALJ Turner provided a description of Penn Power which we shall reproduce below:

"Penn Power is a regulated Pennsylvania public utility and is a wholly owned subsidiary of Ohio Edison Company (Ohio Edison).[1] The history of the company, which includes the purchase, consolidation, and merger of 139 formerly independent operating companies, is set forth in PPC Exh I, Schedule I-A-1. Penn Power's principal executive offices are located at New Castle, Pennsylvania.

"At March 31, 1984, the company will render electric service to approximately 126,633 retail customers. Its service territory, which has a total population of 350,000, encompasses an area of 1,517 square miles in western Pennsylvania, including all of Lawrence and Mercer counties and portions of Allegheny, Beaver, Butler, and Crawford counties. The company additionally provides wholesale electric service to five municipal customers under rates prescribed by the Federal Energy Regulatory Commission (FERC).

"The company's largest source of base-load generation is its own New Castle plant which consists of five separate coal-fired units. In addition, as a member of the Central Area Power Coordinating Group (CAPCO),[2] the company shares in the ownership of

[1]Ohio Edison, a registered holding company under the Public Utility Holding Company Act of 1935, provides electric service throughout a 7,500 square mile area in central and northeastern Ohio.

[2]Other members of CAPCO include Ohio Edison, Duquesne Light Company, Cleveland Electric Illuminating Company, and Toledo Edison Company. In the aggregate, the CAPCO companies service an area of 14,000 square miles in western Pennsylvania and northern and central Ohio with a population of approximately 7 million.

Bruce Mansfield Units Nos. 1, 2, and 3 and Sammis Unit No. 7, all coal burning facilities, and of Beaver Valley Nuclear Unit No. 1. Finally, together with Ohio Edison, Penn Power owns a share of four smaller peaking units (diesel or combustion turbine).

"The principal facilities of the company, including transmission lines and substations, as well as the extent of the company's service territory, are shown on the system map included in PPC Exh I, Schedule I-B-7. Penn Power presently employs approximately 1,860 men and women to meet the needs of its customers."

III. *Rate Base*

A. *Fair Value*

Penn Power has presented only an original cost measure of value in this proceeding. We therefore will adopt the original cost measure of value as the fair value rate base.

B. *Net Original Cost of Plant in Service*

The company has claimed a rate base, or measure of value of its property, of $414,902,134 based upon the future test year ending March 31, 1984, consisting of $548,281,771 of gas plant in service (original cost), less a calculated depreciation reserve of $135,949,107, plus $842,074 for plant held for future use, $3,942,885 for leased nuclear fuel, less deductions of $21,823,515 for advances for construction, deferred income taxes, and deferred investment tax credits, plus a working capital claim of $19,608,026, as set forth in the following tabulation:

	Total Company Original Cost (1)	*Adjusted* (2)	*Adjusted Total* (3)	*Less Resale* (4)	*Pennsylvania Retail* (5)
Plant					
Plant in Service	$567,132,395	$(783,332)	$566,349,063	$18,067,292	$548,281,771
Computed Reserve	140,175,805	(130,532)	140,045,273	4,096,166	135,949,107
Net Plant in Service ...	$426,956,590	$(652,800)	$426,303,790	$13,971,126	$412,332,664
Plant Held for Future Use	875,146	—	875,146	33,072	842,074
Leased Nuclear Fuel ...	4,110,587	—	4,110,587	167,702	3,942,885
Pollution Control Facilities Under Construction at Existing Plants	—	—	—	—	—
Net Plant	$431,942,323	$(652,800)	$431,289,523	$14,171,900	$417,117,623
Deductions					
Customer Advances for Construction.....	315,000	—	315,000	—	315,000
Deferred Income Taxes.	21,817,434	—	21,817,434	771,260	21,046,174
Deferred Investment Tax Credits.....	475,307	—	475,307	12,966	462,341
Total Deductions	$ 22,607,741	—	$ 22,607,741	$ 784,226	$ 21,823,515
Additions					
Working Capital Requirement -- Cash	4,690,562	—	4,690,562	121,044	4,569,518
Other	15,596,800	—	15,596,800	558,292	15,038,508
Total Working Capital.....	$ 20,287,362	—	$ 20,287,362	$ 679,336	$ 19,608,026
Measure of Value	$429,621,944	$(652,800)	$428,969,144	$14,067,010	$414,902,134

Penn Power states that the undepreciated original cost of electric plant in service, at the end of the historic test year (March 31, 1983) was taken directly from the company's continuing property records; that the booked original cost values were originally approved by the commission in the mid-1940s and have since been maintained in conformity with the Uniform System of Accounts for Class A electric companies as prescribed by the Federal Energy Regulatory Commission; and, that the account balances are audited periodically by our staff and, on an annual basis, by a firm of independent certified public accountants.

In deriving the original cost measure of value at future test-year-end, the company adjusted the actual plant balances at March 31, 1983, as set forth in its books of account, to reflect those plant additions and retirements anticipated to occur during the twelve

months ending March 31, 1984. From the resulting figure ($567,132,395), an amount of $783,332, representing the public utility realty tax (PURTA) and associated allowance for funds used during construction (AFUDC) erroneously capitalized in prior years, was deducted.

C. *Generating Capacity*

OCA urges that the value of 72 megawatts of the company's generating capacity be found excessive with a resulting reduction of $28.3 million[3] in the claimed rate base. This adjustment is based upon the OCA's allegation that the company presently has a net total capacity of 752 megawatts compared to a 1983 peak load of 567 megawatts, and that a generating reserve margin of 20 per cent is reasonable. OCA cites numerous decisions of other jurisdictions and this commission, relative to the propriety of a commission making an excess generating reserve adjustment. We need not look to precedent from other jurisdictions in view of the following pronouncement of our commonwealth court on this issue as set forth in Philadelphia Electric Co. v Pennsylvania Pub. Utility Commission (1981) 61 Pa Cmwlth 325, 433 A2d 620:

"PECO contends that because its decisions to construct the eliminated units as well as its decisions to construct every other of its generating units, when made, were prudent, the PUC may not now remove any of these properties from rate base because there is presently excess capacity. This argument, however, misses the point of the determination. The PUC's order specif-

[3]OCA would permit the company to include in the company's cost of service depreciation and operating expenses associated with the claimed excess capacity, thus depriving Penn Power of a return *on* the investment but not a return *of* the investment.

ically states that the PUC was 'not questioning PECO's management decisions made when these units were constructed.' The basis for the order is the finding that to the degree that there is excess capacity, there are generating properties which are not used and useful in rendering service to ratepayers.

"A unit may be properly excluded from a utility's rate base if the investment in that unit is found to be a result of managerial imprudence occurring at the time the decision to invest was made. See, e.g., UGI Corp. v Pennsylvania Pub. Utility Commission (1980) 49 Pa Cmwlth 69, 82-87, 410 A2d 923, 932. It does not follow that a unit prudently constructed must always be included in the rate base. *The touchstone for determining whether or not a prudently constructed unit should be included in a utility's rate base is whether or not, during the test year involved, the unit will be used and useful in rendering service to the public.* Id., 433 A2d at pp. 622, 623 (emphasis added)."

OCA witness Leonard S. Gold testified that Penn Power currently has a total generating capacity of 872 megawatts in the winter and 862 megawatts in the summer, during the future test year. After adjustments recognized future test-year sales of 49 megawatts to Ohio Edison, sales of 21 megawatts to Potomac Electric Power Company, and sales of 28 megawatts to General Public Utilities, the company's capacity for the future test year is 752 megawatts in the summer of 1983 and 762 megawatts in the winter of 1983-84. Mr Gold utilized a peak load of 567 megawatts for the future test year, which would produce a reserve margin of 185 megawatts (752 megawatts – 567 megawatts = 185 megawatts), or a reserve margin of 32.6 per cent.

Mr. Gold recommends a generating reserve margin of 20 per cent for Penn Power in this proceeding, based upon the witness' experiences in the utility industry and prior decision of this commission. Although this witness stated that generation mix, availability of generating units, rates of forced outage, transmission capabilities, interconnections with other utilities, and transfers of energy during emergency situations are factors to be considered in determining a generating reserve margin, he generally recommended a reserve margin of 15 per cent to 20 per cent as being used quite extensively in the electric industry.

The OCA further contends that Penn Power's excess generating capacity will not be reduced in the near future.

We note that Penn Power has claimed no costs, in this proceeding, associated with Perry electric generating Units Nos. 1 and 2, presently under construction; therefore, we are presented with no issues arising from the construction of these generating units or of the propriety of including these generating facilities in rate base.

Although Penn Power has presented substantial argument that all of the company's presently existing generating capacity passes the prudency test when the decisions to construct these plants were made, we are here primarily concerned with the issue of whether the existing generating capacity is used and useful in rendering service to the public. This is the "touchstone" referred to in Philadelphia Electric.

Penn Power contends that all of its generating facilities are, in fact, used in providing electric service, and that all of the company's generating plants, with the ex-

ception of facilities used solely for peaking purposes, are projected to operate at capacity factors of 56 per cent or higher during the future test period.

The company further contends that, in all likelihood, its reserve margin will drop significantly below 30 per cent during the period in which the rates determined in this proceeding will be in effect. In this regard, the company's witness Pazak testified that the company has been advised that one of its major industrial customers, Babcock and Wilcox, anticipates adding 40 megawatts of load in the second half of 1984, which additional load would reduce its reserve margin to approximately 26 per cent; and that if its peak load of 577 megawatts for 1981 were repeated, its reserve margin would fall to 23.8 per cent.

The company also presented evidence concerning increased peak requirements which could materialize as a result of an economic recovery in its service territory. Dr. Gerber testified:

"Penn Power Company had already reached a summer peak of 577 megawatts in 1981 prior to the slide into the deep recession that was experienced during the latter half of 1981 and 1982. Thus, the projection of 572 megawatts for the summer of 1984, shown on OCA Exhibit LSG-2, is less than the peak already reached in 1981 by Penn Power Company. Even if the anticipated 40 megawatts of additional Babcock and Wilcox load expected to come on line in 1984 were ignored, the economic recovery we are presently experiencing could result in a peak demand on the Penn Power system considerably above the projection of 572 megawatts for the summer of 1984 and well above the winter, 1984-85 projection of 589 megawatts. For example, the twenty

largest customers served by Penn Power Company reached a peak in 1981 that was almost 40 per cent above the peak demands they reached since then. In short, as economic recovery proceeds, one can expect that the demand level will return to the highest levels reached previously and could go well beyond that level."

In further support of its contention that all existing generating capacity is used and useful in the rendition of electric service, Dr. Gerber presented the following testimony indicating that the existing production facilities have generated significant economic benefits in terms of lower capital and operating costs:

"Penn Power Company and its customers have been the beneficiaries of the company's efforts to increase coordination and integration with other systems through its participation in CAPCO as well as its being part of the Ohio Edison system. This has permitted the company to take advantage of various substantial economics of scale which would not have been available were it operating independently. For example, Penn Power Company has participated in the ownership of Bruce Mansfield Units 1, 2, and 3. These are 835-megawatt units of which Penn Power has ownership of a total of 144 megawatts. Its ownership is distributed among the three units and, therefore, Penn Power Company has distributed its risk in the operating efficiency and unit availability of its 144 megawatts among those three units rather than risking it all in a single unit. Penn Power Company has obtained the economies of scale available from the construction of an 835-megawatt unit at a time when it could not, standing alone, given its size, have been capable (at least with any degree of prudence) of building a unit any larger

than 100 or 150 megawatts. Even that size would have been stretching things quite a bit. The difference in the construction costs between the 835-megawatt units and 100- or 150-megawatt units could well have been somewhere in the neighborhood of $75 to $100 per kilowatt of capacity. It is a rather simple matter of multiplication to determine what that has saved Penn Power Company and its customers in carrying charges on fixed investment. One hundred and forty-four thousand kilowatts which achieve a saving of $100 per kilowatt results in an investment saving of $14.4 million. A saving of that magnitude in investment saves carrying charges for Penn Power Company and its customers of something in the neighborhood of $2.5 million a year."

Dr. Gerber also testified that the level of needed capacity must be evaluated in light of the load and generating mix characteristics of the particular electric system under consideration. For example, this witness stated that a significant share of Penn Power's industrial load operates at high load factors with leapfrogging peaks which necessitates the planning of maintenance work during peak periods. He testified:

"Penn Power Company's load is characterized by a significant share of industrial load that operates at high capacity—i.e., load—factors. The result is that the system as a whole has a very high capacity (load) factor with leapfrogging peaks. This is, the peak in the summer can exceed the peak in the previous winter and then the peak in the following winter will exceed the peak in the previous summer. This system also has a capacity (load) factor that is close to 70 per cent. This means that it is necessary to plan to do maintenance during the peak periods. It also increases the probability that there will be forced outages of generating

capacity during the peak periods. Indeed, if one examines the Penn Power Company maintenance schedules and their unexpected forced outage experience, one finds that some planned maintenance is scheduled for the peak periods and both forced outages and maintenance outages occur throughout the year and frequently during peak periods. Under these circumstances, the system requires a higher level of reserves to permit it to accommodate such outages.

The OCA has presented testimony and extensive argument in support of its recommended 20 per cent reserve generating capacity which it characterizes as being an acceptable standard or bench mark in the electric generating industry. This commission, as early as 1972, urged a reserve capacity of *at least 20 per cent* in Pennsylvania Pub. Utility Commission v Duquesne Light Co. (1972) 46 PUC 427, 437, 438 in order "[T]o cover peak loads, scheduled maintenance, and forced outages in order to avoid blackouts, load curtailments, and voltage reductions." We do not believe, however, that a capacity reserve margin of 20 per cent or any other specific percentage could or should apply as an industry standard. An acceptable reserve generating capacity margin for any particular electric utility is dependent upon the generation mix, availability of generating units, peak-load requirements, the period during which the peaking capacity is required, rates of forced outages, transmission capabilities, interconnections with other utilities, and transfers of energy during emergency. These are some of the operating factors which must be considered when reaching a determination concerning an acceptable generating reserve margin.

As stated previously, Penn Power is not in this proceeding making a rate base claim for newly con-

structed or recently completed generating capacity which would, of necessity under current conditions, result in an increase in its recently experienced reserve generating capacity margin.

In reaching a determination of whether a generating capacity adjustment should be made in this proceeding, we have given consideration to the established fact that a significant share of the company's industrial load operates at a high load factor which would require outages of generating capacity during peaking periods in order to perform required maintenance.

We take notice that the company's present reserve generation margin of approximately 32 per cent is attributable, in part, to the depressed economic conditions in Penn Power's service territory, a condition over which the company has no control. This is not to state that a generating capacity reserve margin adjustment would be improper in all circumstances when attributable to depressed economic conditions. However, in the case of Penn Power, the economic conditions existing in the service area have contributed to the existing reserve margin which we do not find to be excessive in accordance with the foregoing discussion. Accordingly, the OCA's adjustment will not be made.

D. *Depreciation Reserve*

Penn Power claims a calculated, or "computed" depreciation reserve of $135,949,107 at March 31, 1984, which was prepared in accordance with a methodology similar to that used in its calculated depreciation reserve presented in prior rate proceedings before this commission.

In order to calculate accrued depreciation at March 31, 1984, the company's witness Earl M. Robinson, vice

president and general manager of Weber, Frick & Wilson, Inc., determined the attained ages and estimated service life characteristics for each group of depreciable utility plant. Mr. Robinson relied extensively on a comprehensive depreciation study prepared by Weber, Frick & Wilson, Inc., for the company in conjunction with its 1979 rate filing (Docket No. R-7912020). After analyzing and testing the results of that study, this witness concluded that, with the exception of the production plant accounts, the service lives and life characteristics developed therein remained appropriate for use in the current proceeding.

Major generating plant was depreciated by utilizing the life span procedure. This methodology consists of the development of a life span or probable retirement date for each generating unit which, when combined with a curve reflecting anticipated interim component retirements, yields the appropriate amount of accrued depreciation attributable to the plants in question. The interim retirement rates employed by Mr. Robinson for purposes of life spanning the company's investment in steam and nuclear production plant facilities were the same as those which were presented to and approved by the commission in Pen.. Power's most recent fully litigated rate proceeding. See: Pennsylvania Pub. Utility Commission v Pennsylvania Power Co. (1982) 55 Pa PUC 552.

In Penn Power's prior rate proceeding, Docket No. R-811510, Jan. 22, 1982, we directed (55 Pa PUC at p. 590):

"10. That Pennsylvania Power Company perform a study to allocate its book reserve over each plant account by vintage for all production plant. Prior to com-

mencement of this study, the company shall secure the approval of [the] electric division in the bureau of rates as to the allocation methodology to be used in the study."

Pursuant to the above directive, the company met with our staff to determine the appropriate allocation methodology to be used in the depreciation reserve study. Based on those discussions, the scope of the study was expanded to encompass all plant in service. On February 18, 1983, the completed study was submitted by Penn Power to the commission. The company contends that although it invested a significant amount of time and effort in preparing the study which we directed be prepared, and although it is of the view that this study can play a valuable role in the ultimate resolution of the appropriate depreciation reserve for Penn Power, it nevertheless contends that its calculated reserve, and annual depreciation expense as claimed by the company should be approved in this proceeding.

Alternatively, Penn Power urges that if we should conclude that the conversion from a calculated depreciation reserve to a book reserve should be initiated at this time, the February 18, 1983, report represents the most reasonable and equitable approach to the depreciation reserve issue. Following is a summary of the company's proposal as described by Mr. Robinson:

"The company proposed to change, for both rate making and book purposes, the basis of its depreciation expense and depreciation reserve. In making this change, the company proposed to adopt the average remaining life methodology in lieu of the presently utilized whole life average service life method. Further, the company proposed for rate making to change from

using a calculated depreciation reserve to a book depreciation reserve. The starting point depreciation reserve for going forward with average remaining life was to incorporate the calculated depreciation reserve as of the point in time in which the methods were changed. Going forward from the changeover date, the company agreed to utilize the same depreciation rates per books as allowed in its rate cases together with an annual recalculation of depreciation rates, utilizing approved service life parameters, as a constant trueup procedure for its book reserve. Further, the company agreed to complete timely depreciation service life studies to update the service lives of the property. Also included in the proposal was a request to incorporate prospective net salvage into the annual depreciation rates. Given the commission's current policy and position with regard to prospective net salvage, the company would accept the continued use of the five-year average experienced net salvage in lieu of its proposal. In summary, the company's rate base and depreciation expense would be based upon the adoption of the average remaining life depreciation method going forward from a starting point depreciation reserve equal to the calculated reserve as of the changeover date. The difference between the company's calculated reserve and book reserve at that point in time would be amortized over an appropriate period below the line."

Trial staff has recommended that, in this proceeding, a move be initiated toward the use of the book depreciation reserve to calculate the appropriate depreciation reserve and to the use of remaining life for the purpose of calculating the annual depreciation expense.

Trial staff witness Michael J. Gruber developed his adjusted book depreciation reserve by taking as the

starting point, the calculated reserve *at December 31, 1971, adjusted to reflect the depreciation expense that would have accrued since that time using the service lives submitted by Penn Power or approved by the commission in each rate case during that period.* In developing this adjusted book reserve, he relied exclusively on data supplied by the company.

Mr. Gruber then calculated the appropriate depreciation expense using remaining life depreciation. Under this methodology, the remaining life for a unit of property is calculated and the net depreciated value of plant is calculated. This net value is collected equally over each year of the unit's remaining life. Stated differently, the reserve is deducted from the original cost rate base, and the net plant is then divided by the average remaining life to arrive at the annual expense by account. These account expenses then are totaled to derive the annual depreciation expense.

In substance, Mr. Gruber actually reconstructed what the company's book reserve would have been *had the company reflected on its books the accrual rates requested in rate cases since 1972.* The following tabulation graphically demonstrates that the difference or variation between the calculated depreciation reserve and the book depreciation reserve has occurred since 1971:

ANNUAL DEPRECIATION RATE VARIANCE

Year	*Book Rate* (1)%	*Calculated Rate* (2)%	*Book Over Calculated* (3)%
1971	3.11	3.13	(0.02)
12-31-71			
1972	3.12	2.64	0.48
1973	3.13	2.61	0.52
6-30-73			
1974	3.13	2.61	0.52
1975	3.13	2.59	0.54
2-28-75			
1976	3.13	2.59	0.54
1977	3.13	2.66	0.47
7-31-77			
1978	2.60	2.66	(0.04)
1979	2.63	2.79	(0.17)
9-30-79			
1980	2.71	2.73	(0.02)
12-31-80			
1981	2.71	2.79	(0.08)
1982	2.88	2.81	0.07
12-31-82			

DEPRECIATION RESERVE VARIANCE

Year	*Book 000s* (1)	*Calculated 000s* (2)	*Book Over Calculated 000s* (3)
1971	$21,526	$21,951	$ (425)
12-31-71			
1972			
1973	25,142	20,648	4,494
6-30-73			
1974			
1975	29,153	23,932	5,221
2-28-75			
1976			
1977	35,425	26,009	9,416
7-31-77			
1978			
1979	42,930	32,702	10,228
9-30-79			
1980	48,489	38,401	10,088
12-31-80			
1981	52,361	43,690	8,671
12-31-81			
1982	58,023	49,334	8,689
12-31-82			

The methodology developed and utilized by Mr. Gruber produces an adjusted book depreciation reserve which closely approximates the amount of the book depreciation reserve had the appropriate depreciation expenses, as collected through rates, been booked by the company during the period in question. Penn Power's book depreciation reserve is higher than the calculated reserve for the reason that the company booked higher annual depreciation accruals, during the period in question, than would have been accrued had the company used the annual accruals used in the rate proceeding during this period. The present customers of Penn Power should not be required to pay higher rates based upon this over-accrual. Continued use of the company's calculated depreciation reserve would result in customers being required to pay for depreciation expense which has already been collected from customers under rates approved by this commission since 1971.

Trial staff also proposes that we direct Penn Power to meet with staff and develop a standardized yearly filing for depreciation. Such a filing would include the submission of annual retirement data by account as well as monthly calculations of book depreciation expense and a retirement index by which the book reserve can be monitored. When retirements exceed this index, Penn Power would file an explanation of that account. We will adopt trial staff's proposal.

We concur with the recommendation of the ALJ that trial staff's adjustment to book depreciation reserve in the amount of $8,098,290, as corrected, be adopted, and that the depreciation expense adjustment (reduction) of $241,680 also be adopted. We also will direct the company to meet with the bureau of rates for the purpose of developing a standardized annual depreciation filing.

E. *Cash Working Capital*

Penn Power has claimed a jurisdictional working capital allowance of $19,608,026 consisting of (i) cash needs for operating and maintenance expenses, including taxes, and average prepayments of $4,690,562 (total company); and (ii) fuel inventory, material and supplies, and energy rate deferral costs of $15,596,800 (total company).

The company describes the term working capital as stated in Pittsburgh v Pennsylvania Pub. Utility Commission (1952) 370 Pa 305, 94 PUR NS 353, 355, 356, 88 A2d 59:

"Cash working capital ordinarily is the amount of cash required to operate a utility during the interim between the rendition of service and the receipt of payment therefore [sic]. It is the bloodstream that gives life to the physical plant and facilities of the enterprise. It can readily be seen that, initially, at the commencement of operation, capital supplied by investors must, in order for the company to function, include such working cash in addition to the amount required for physical plant and facilities. Its allowance as an element of fair value for rate-making purposes has been approved by decisions of both the superior and supreme courts of this state and of the appellate courts of other jurisdictions."

1. *Lead-lag Study*

Penn Power's claim for cash required in advance of the receipt of revenue to defray the cost of operating and maintenance expenses was determined from the

same lead-lag study which was utilized in the company's two most recent rate proceedings. That study indicated an average lag in the receipt of revenue of 42.22 days and varying lags in the payment of production power expenses (40.22 days), payroll (11.90 days), and other goods and services (37.43 days). The company claims a billing lag of 7.22 days, the time required to read the meter, process the read, and prepare the bill. Penn Power sends the data to its parent, Ohio Edison, which prepares and mails the bill.

The OCA contends that the company's 7.22-day billing lag period is overstated since the data upon which the billing period is based is over three years old.

Penn Power, in cooperation with Ohio Edison, has installed a new meter reading system called the CIS system. This system was begun in September, 1983, and was expanded to various divisions in October, November, and December, 1983. Although the company's witness Mr. Pazak initially testified that this system will be completed in January, 1984, he later revised this testimony by indicating that full completion and operation of this system would occur at the end of the future test year. The following testimony describes the faster transmission of billing data under the new system.

"There's a new meter reading system known as a Porta Processor. The meter reader carries a walkie-talkie type meter reading device and punches in the number and records it. At night, it gives them the certain signals about each account. At night that is plugged and it's transmitted directly for billing purposes at that point for each [billing] cycle."

OCA witness Eckhaus would reduce the 7.22-day billing lag period to five days, this reduced figure being

essentially based upon a decision of the public utilities commission of Ohio (Case No. 82-1025-EL-AIR) which concluded that, in the case of Ohio Edison, a five-day billing lag period was appropriate based upon the introduction of the subject CIS system.

The ALJ, in discussing this issue, notes that the OCA's proposed billing lag reduction is not based upon any analysis of Penn Power's procedures but rather upon the implementation of the CIS system by Ohio Edison, and concludes that the Ohio Edison case is not, in and of itself, an adequate basis for adopting the OCA adjustment.

We agree with the ALJ that the company is basing its projections on a lead-lag study which is not current. The ALJ also currently concluded that the OCA's adjustment is based primarily upon the testimony of the company's witnesses relative to the installation of the CIS system. Penn Power admits that this CIS system will be essentially installed and in operation by the time the rates in this proceeding are placed in effect. The purpose behind the installation of the CIS system is to reduce the billing lag period. This system will be operational when the rates developed in this proceeding become effective, and we would clearly be remiss were we not to reflect this reduction in the billing lag in our determinations. Accordingly, we concur with the recommendation of the OCA that the billing lag period be reduced from 7.22 days to five days and the revenue lag from 42.22 days to forty days.

2. *Federal Income Tax Lag*

Penn Power's claimed federal income tax payment lag approximates fifty-nine days (58.95), and is based on the statutory estimated tax payment schedule set forth

in current regulations of the Internal Revenue Service. The company also utilized existing, not proposed rates, in developing the tax payment lag.

OCA witness Eckhaus urges that the 59-day payment lag be increased to 174.1 days based upon the actual payments made by the company for the calendar year 1982 federal income tax liability. OCA's essential argument is that the last full year's actual payment experience (1982) should be used to develop the tax payment lag.

Penn Power opposes the OCA adjustment on three grounds. First it argues that Mr. Eckhaus was either unaware of or chose to ignore the fact that the Internal Revenue Service revised its regulations during the past year, and that in 1982 the company was required to pay only 80 per cent of its current year's federal income tax liability by December 15th, the remaining 20 per cent in equal installments on March 15th and June 15th of the following year. Under present IRS regulations, 90 per cent of the current year's tax liability must be paid by December 15th with the remaining 10 per cent payable the following March 15th.

Secondly, the company argues it has substantially revised the basis upon which it estimates its current year's tax liability in order to avoid potential underpayment penalties. Stuart G. McDaniel, senior vice president of Associated Utility Services, Inc., described this change as follows:

"[T]he method by which Penn Power presently estimates its income tax liability is different from that which it employed in 1982 in order to assure compliance with the Safe Harbor Provisions of the Internal Revenue Code and thereby avoid the payment of non-

deductible penalties. In 1982, Penn Power based its April 15, 1982, payment on the actual results of operations for the three months ended March 31, 1982, and budgeted results for the remaining nine months of the calendar year. Similarly, this procedure was followed with respect to subsequent payments on June 15th, September 15th, and December 15th.

"Because of the change in the tax law, which became effective January 1, 1983, Penn Power now bases its installments for April 15th, June 15th, and September 15th on the basis of annualized actual results of operations. For example, the April 15th, 1983, payment was based on the first three months of 1983 annualized without regard to the budget. The change in the method of estimating taxes, along with the acceleration of the payment schedule as a result of new IRS regulations, has accelerated Penn Power's payments to the federal government."

Thirdly, the company argues that it grossly underestimated its federal income tax liability for 1982 when it made the first three installment payments, the basis upon which Mr. Eckhaus developed his recommended 174.1-day payment lag. Mr. McDaniel testified:

"As I mentioned previously, Penn Power's estimated 1982 federal income tax payments were based on a combination of actual results and budgeted data. Significantly, however, the 1982 budget did not include any additional revenues relative to the company's rate application at Docket No. R-821918, which was filed on April 5, 1982. Moreover, even if anticipated revenues had been included in the budget, they would have been eliminated for this purpose, since the company's practice is not to pay taxes in advance on the basis of as-

suming what the commission might or might not award in any given rate case. As it turned out, the 1982 rate case was settled and new rates became effective in September 1982. The increased rate levels materially affected the revenues generated during the fourth quarter of 1982 and, in part, resulted in higher estimated payments in December 1982, March 1983, and June 1983 than would have otherwise been the case."

Under present Internal Revenue Service regulations the company must pay 90 per cent of its tax liability by December 15th, and the remaining 10 per cent by the following March 15th. Penn Power testified that it bases its April 15th, June 15th, and September tax installment payments on the basis of annualized actual operations, thus accelerating the company's tax payments.

Our review of Mr. McDaniel's testimony substantiates the company's contention that the 1982 tax payments, which formed the basis of the OCA's adjustment in the tax payment lag, were grossly underestimated. The 1982 budget did not reflect revenues from increased rates; and although the company testified that it does not as a practice anticipate increased revenues from proposed rates, nevertheless the 1982 tax payments were clearly understated. For this reason, we decline to accept the OCA's proposed lag adjustment which was based upon atypical data.

We have explained our reasoning for rejecting the 174.1 days tax lag payment advocated by the OCA. We are confronted with an issue difficult of resolution for the reason that actual tax payments may vary for numerous reasons beyond the control of the company. We consider it appropriate, under these circumstances,

that the actual income tax regulations payment schedule be utilized. We therefore accept the company's 59-day lag period for federal income tax payments.

F. *Fuel Inventories*

As part of its test-year claims for working capital, Penn Power has included claims for coal and oil inventory during the future test year. Those portions of the company's working capital attributable to coal and oil inventories and materials and supplies were described by Messrs. Pazak and Kauffman and are set forth in detail in the company's Exh 1 (Future). Penn Power contends that the claimed amounts, which are based on projected 13-month average balances, are designed to provide the company with the levels of inventory required to maintain service reliability notwithstanding supply disruptions. The unit prices employed in valuing the claimed quantities of coal and oil reflect the estimated average inventory prices at March 31, 1984, with the exception of that portion of Mansfield coal from the Quarto mine which, consistent with the commission's order at Docket No. R-811510, has been priced out at the "Quarto cap" price.

1. *Coal Inventories*

The OCA submits that both the projected inventory levels and projected future test-year-end prices for coal are overstated and must be adjusted. That adjustment reduces Penn Power's rate base claim from $9,340,471 to $7,991,000. This adjustment has two bases.

First, according to OCA, the inventory level estimation process used by Penn Power is flawed, does not meet the company's conceptual basis for this claim, and therefore produces inventory levels which are too high.

The flaw from OCA's point of view is that the only supply interruptions projected by the company are cold weather interruptions in the transportation of coal, yet larger inventories are projected in several spring and summer months than in several fall and winter months. OCA therefore established a range of tonnage required to keep inventory at a level required to provide service without interruptions and picked the midpoint of that range for each month these ranges were provided by Penn Power.

Second, the inventory prices claimed for valuing the inventory, according to OCA, is also too high, since it is a projected price for 1984; OCA recommends using the last known price submitted by Penn Power for September, 1983.

Penn Power argues that OCA has not provided a true critique of its estimating methodology, but merely developed a different methodology to produce a different result. The company contends that as Mr. Pazak explained:

"Mr. Eckhaus reduces the company's requested coal inventory levels to reflect the midpoints of what he perceives to be appropriate 'ranges.' The ranges which he utilizes, however, were expressly based on the assumption that the company would not experience any kind of supply disruption. Unfortunately, the company cannot rely on such assumptions for planning purposes if it is to continue to provide safe and reliable service. Moreover, it should be noted that, unlike his proposed adjustments to oil inventories, materials and supplies, and prepayment balances, Mr. Eckhaus chose to ignore actual data regarding coal inventories. As a review of the company's response to OCA Interrogatory RR/RB 66

indicates, the average coal balances during the first six months of the future test year substantially exceeded the tonnage levels proposed by Mr. Eckhaus at all three generating facilities in question and in two instances (Sammis No. 7 and Mansfield) actually exceeded the levels claimed by the company."

Mr. Pazak further noted that if Mr. Eckhaus had consistently applied what otherwise appeared to have been his preferred methodology—i.e., a combination of actual and budgeted data—the resulting average monthly coal balances would have been virtually identical to the levels claimed by Penn Power.

Penn Power's future test-year claim is approximately $2.5 million less than its historic experience.

We concur with the recommendation of the ALJ and decline to accept the OCA's adjustment to coal inventory levels. We agree with the company that it is improper to assume that the company will experience no supply interruptions. Furthermore, the actual average coal balances during the first six months of the future test year substantially exceeded the tonnage levels at three generating facilities as advocated by the OCA; and the actual coal balances exceeded the tonnage levels claimed by the company for Sammis No. 7 and for Mansfield generating units.

The ALJ recommends that the actual coal prices for September, 1983, for New Castle ($33,205) and for Sammis No. 7 ($33,947) be used to price coal inventories. The recommendation of the ALJ is based upon evidence which shows that actual coal cost for New Castle and Sammis No. 7 are lower than projected by the company, and the fact that, historically, test-year figures do not indicate a test-year-end increase as

projected by the company. We concur with the recommendation of the ALJ regarding the pricing of coal inventories, and accept the basis for this recommendation.

2. *Oil Inventories*

OCA argues that both the projected oil inventory levels and projected future test-year-end prices for oil are overstated and must be adjusted, and would reduce Penn Power's rate base claim from $153,763 to $144,000. Penn Power's historic valuation of these same inventories was $175,801, or $18,000 lower than the historic cost level.

Penn Power projects that it will maintain the same level of oil inventories at each of three plants or units in each month during the future test year. The company values this inventory at its projected purchase cost per gallon at each plant for the last month of the future test year. At all three of these units, New Castle, Sammis No. 7, and New Castle (EMD), the price is at, or is next to, the highest projected purchase price. At the fourth plant, Mansfield, the price is the lowest purchase price.

Actual experience shows that oil inventories at these plants vary from month to month. In many instances, these fluctuations are quite large. Historic and actual prices also show variations in price, particularly for light-off fuel at New Castle and Sammis No. 7.

OCA has calculated an average level of inventory based on the actual test-year experience, except in the case of Mansfield which includes what OCA considers unexplained increases, and a valuation of it based on the last known monthly actual purchase prices for oil at each unit, except for Sammis No. 7, where this price is higher than previous months for unexplained reasons.

The ALJ concluded that the OCA had not demonstrated that its estimating technique was in any way superior to or produces a more appropriate result than Penn Power's. We concur with the conclusion and find the company's claim for oil inventories acceptable, being based upon reasonable projected purchase prices for oil at each plant for the last month of the future test year.

G. *Plant or Land Held for Future Use*

The company claims $842,074, for land held for future use, representing Penn Power's investment in land held for future use as transmission line and substation sites. The location of each such site, as well as the anticipated in-service date for the underlying project, are set forth in PPC Exh I, Schedule I-A-14. As noted on this schedule, and described by Mr. Pazak, the claim involves five rights of way with in-service dates prior to 1993.

OCA's witness Eckhaus has proposed removing this claimed amount entirely from rate base. His proposal has two bases. First, he argues that plant (including land) held for future use is indistinguishable from CWIP, and that it should be allowed to accrue carrying costs and then these costs and the plant be included in rate base when the plant becomes used and useful.

Second, OCA argues that § 1315 of the Public Utility Code, 66 Pa.C.S. § 1315, signed into law on December 30, 1982, when read in conjunction with § 102 of the code, 66 Pa.C.S. § 102, requires that no utility property, including real property, should be considered used and useful until it is actually used in providing present utility service. The land upon which this claim is based will not be used in the future test year, and

therefore OCA contends that the entire claim should be disallowed.

Penn Power argues that the claim should be allowed because it is uncontested that all of the sites which the company had requested meet the two-part test established by the commission; i.e., each is held under a definite plan for use in the company's future electric operations and will be in service within the next ten years. Penn Power has presented evidence which establishes that it has met the two-part test as described in Pennsylvania Pub. Utility Commission v Philadelphia Electric Co. (1981) 55 Pa PUC 78, 87, 88, 42 PUR4th 475, 485, wherein we stated:

"Even were we disposed to change our policy at this time and based upon this record, our test year for the inclusion of land held for future use is comprised of two criteria and shall not be modified. As stated in Pennsylvania Pub. Utility Commission v Pennsylvania Electric Co. (1976) R.I.D. 172:

" 'It is the current policy of the Pennsylvania Public Utility Commission to allow the inclusion of land held for future use in rate base (1) *when definite plans are available and* (2) *said utilization will occur within a reasonable time.* The commission has earmarked a reasonable time in recent rate decisions as being up to ten years.' "

The company has shown a definite plan for the use of this property and that the property will be in use within the ten-year period. The "policy" stated above is based upon our conclusion that the acquisition of transmission line rights of way and land for substation sites must frequently, and of necessity, be acquired substantially prior to actual construction of the facilities which

eventually will occupy the land. Customers of Penn Power actually benefit from the acquisition of such land and land rights prior to the commencement of actual construction since if these land rights are acquired immediately prior to construction, the acquisition costs may be higher, and in many instances, the land sites may not be available for acquisition at a later date. We of course do not condone the inclusion of the investment in land and land rights for which there is not definite plan for use within a reasonable period of time.

Turning to the OCA's argument that § 1315 of the Public Utility Code precludes the inclusion of property, including real property, as used and useful until actually placed in service, we repeat here our contrary legal conclusion as stated in Pennsylvania Pub. Utility Commission v Metropolitan Edison Co. Docket No. R-822249, Oct. 9, 1983:

"While the cost of unimproved land or land rights might be considered to be a component of 'the cost of construction of a facility,' as that term is used in the statute, the subject of plant held for future use, has, historically, been a subject separate and distinct from that of construction work in progress. We believe that it would be an unreasonable reading of the statute, to apply the definition of used and useful in such a manner as to result in a reversal of commission practice regarding plant held for future use, in the face of legislative silence on this separate and distinct regulatory subject." See also Pennsylvania Pub. Utility Commission v Pennsylvania Power & Light Co. (1983) 55 PUR4th 185; Pennsylvania Pub. Utility Commission v Philadelphia Electric Co. Docket No. R-822291, Nov. 23, 1983; Pennsylvania Pub. Utility Commission v Pennsylvania Electric Co. Docket No. R-822250, Oct. 19, 1983.

The company's claim for land held for future use is accepted.

IV. *Fair Rate of Return*

In reaching a determination of a fair rate of return for the company in this proceeding, we will first review the legal standards which we are required to follow.

Penn Power, a public utility, is entitled to an opportunity to earn a fair rate of return. See Pennsylvania Gas & Water Co. v Pennsylvania Pub. Utility Commission (1975) 19 Pa Cmwlth 214, 341 A2d 239; Riverton Consol. Water Co. v Pennsylvania Pub. Utility Commission (1958) 186 Pa Super Ct 1, 24 PUR3d 9, 140 A2d 114. The return authorized must not be confiscatory, and must be based upon evidence presented. See Pittsburgh v Pennsylvania Pub. Utility Commission (1949) 165 Pa Super Ct 519, 82 PUR NS 572, 69 A2d 844.

Among the factors to be considered in determining a fair rate of return are: the earnings which are necessary to assure confidence in the financial integrity of the utility and to maintain its credit standing; the payment of dividends and interest; the business and financial risks; and the circumstances attending the origin, development, and operation of the business. Pennsylvania Gas & Water Co. v Pennsylvania Pub. Utility Commission (1956) 182 Pa Super Ct 35, 125 A2d 603.

Although the cost of capital and fair rate of return are not always synonymous, cost of capital is one of the important bases upon which a fair rate of return is determined. Lower Paxton Township v Pennsylvania Pub. Utility Commission (1974) 13 Pa Cmwlth 135, 317 A2d 917. The generally accepted method of arriving at

a fair rate of return is the cost of capital approach. The rate-making authority examines the utility's capital structure to identify the sources of the utility's capital. It then ascertains the cost of each component: the cost of debt, determined essentially by the annual interest requirements of the utility's bonds; the cost of preferred stock; and the cost of common equity, determined by the return required to sell such equity stock upon reasonable terms in the market. Pennsylvania Pub. Utility Commission v Bell Teleph. Co. of Pennsylvania, R-811819, March 8, 1983.

The constitutional requirements applicable to the derivation of a fair rate of return are set forth in Bluefield Water Works & Improv. Co. v West Virginia Pub. Service Commission, 262 US 679, PUR1923D 11, 67 L Ed 1176, 43 S Ct 675, and in Federal Power Commission v Hope Nat. Gas Co. (1944) 320 US 591, 51 PUR NS 193, 88 L Ed 333, 64 S Ct 281. In Bluefield the United States Supreme Court stated (PUR1923D at pp. 18, 20, 21):

". . . Rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility of its property in violation of the Fourteenth Amendment.

". . . A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has

no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the utility and should be adequate under efficient and economical management to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties."

In Hope, the United States Supreme Court stated (51 PUR NS at pp. 200, 201):

"The rate-making process, under the act—i.e., the fixing of just and reasonable rates—involves a balancing of the investor and the consumer interest. . . . Regulation does not insure that the business shall produce net revenues. But such considerations aside, the investor interest has legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital cost of the business. These include services on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. The return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."

Having stated the legal standards which apply to our determination of a fair rate of return, we will now discuss the evidence of record relative to this issue.

We quote, with our concurrence, the following statement of ALJ Turner concerning our enunciated goal, in setting a fair rate of return, of achieving a proper

balance between the conflicting interests of the stockholders and the ratepayers:

"The commission has consistently found it worthwhile to reiterate that its goal in setting a rate of return is to be fair to the stockholders, and fair to the ratepayers, and to achieve proper balance between these two conflicting interests before launching into any analysis and valuation of varying methods presented in testimony. In addition, it has noted that the plethora of methodologies and variations thereof, the variety of source data, and the diversity of the achieved results, is almost overwhelming. A discussion of each facet of each methodology of each witness and comments upon the appropriateness of the data sources each has utilized, is impossible, and I add, would contribute significantly to the regulatory process. As the commission has discussed from time to time in various opinion and orders, each of the methods presented in these proceedings have inherent weaknesses and infirmities, with the consequence that there is probably no conclusion of any witness which is capable of being adopted without modification or adjustment."

A. *Capital Structure*

All parties accept the company's proposed capital structure for the future test year ending March 31, 1984, consisting of 51.8 per cent long-term debt, 13.9 per cent preferred stock, and 34.3 per cent common equity, which we find acceptable.

B. *Cost of Long-term Debt*

All parties accept the embedded long-term debt cost rate of 10.25 per cent as shown by Mr. Hanley. We find this 10.25 per cent cost rate for long-term debt acceptable.

C. *Cost of Preferred Stock*

All parties accept the embedded preferred stock cost rate of 9.49 per cent as shown by Mr. Hanley. We find this 9.49 per cent cost for preferred stock acceptable.

D. *Cost of Equity*

We are confronted with the normal array of methodologies and calculations of the various parties in support of each parties' recommended cost of equity. The following tabulation summarizes the recommended cost of equity, and the methodology utilized by the parties in developing the recommended equity cost rate:

Methodology	*Penn Power (Hanley)* (1) %	*Staff (O'Donnell)* (2) %	*OCA (Woolridge)* (3) %
Discounted Cash Flow	16.6	14.94-16.14	14.8
Risk Premium	16.9	14.3	14.8
Earnings-price Ratio	17.3	12.17-14.29	14.27
Earnings-net Proceeds	19.1		
Capital Asset Pricing Model	16.4		

E. *Summary of Methodologies of Various Parties*

Frank J. Hanley, senior vice president of Associated Utility Services, Inc. presented testimony in support of a cost of common equity of 17 per cent. Mr. Hanley's recommendation was derived primarily from a consideration of the discounted cash-flow analysis (DCF)—16.6 per cent, and risk premium analysis—16.9 per cent. He also considered, in order of significance, earnings-price ratios (E/P)—17.3 per cent, earnings-net proceeds (E/NP)—19.1 per cent, and the capital asset pricing model (CAPM)—16.4 per cent.

All of the company's stock is owned by Ohio Edison. Mr. Hanley studied financial data for two barometer

groups, Moody's 24 utilities, and 11 Baa-rated operating electric companies listed by Moody's Investors Service, Inc. This witness, however, placed the greatest emphasis on data for the 11 Baa-rated electric utilities for the reason, in his view, that their risk level is most similar to that of Penn Power.

Mr. Hanley reviewed financial data for the barometer companies for the period 1978-82 and spot data for 1983, and also considered near-term projections. This witness recommends use of immediate past and projected near-term data as being the information used by investors in making decisions and because this information provides a realistic view of investor expectations for the approximate 12- to 18-month period during which the rates in this proceeding can be expected to be in effect.

Trial staff, through its witness Andrew R. O'Donnell, commission financial analyst, recommended a common equity cost rate of 15.25 per cent. Mr. O'Donnell's equity cost recommendation was based upon a DCF analysis and an E/P ratio analysis[4] for a barometer group of three operating electric companies, for Moody's 24 public utilities, and for Ohio Edison.

Mr. O'Donnell analyzed financial data for American Electric Power Company, Duquesne Light Company, and Toledo Edison Company (the three electric companies) which he considered a representative group of companies having risks similar to Penn Power, having

[4]Comparison Group	*DCF*	*September 30, 1983 Earnings-price*
	(1)%	(2)%
Ohio Edison	14.94	14.29
Barometer Group of Three	15.00	12.17
Moody's 24	16.14	14.18

met his criteria of (i) being publicly traded companies with electric operating revenues greater than 95 per cent of all revenues; (ii) having an expected fuel mix which contained both nuclear and coal, with a combined total of approximately 85 per cent or more; and (iii) having a Moody's bond rating of A3-Baa3.

This witness placed greater emphasis on market data of Ohio Edison and the barometer group of three electric utilities than on Moody's 24.

Mr. O'Donnell considered Ohio Edison appropriate for comparability purposes since Penn Power and Ohio Edison possessed similar management, Moody's credit ratings, fuel generation mix, revenue distribution, capital structure, and for the reason that both companies are members of CAPCO, and Ohio Edison owns all the common stock of Penn Power. This witness considered his group of three electric utilities as being comparable with Penn Power, having similarities in service territory, effective tax rate, revenue distribution, coverage ratio, and capital structure.

Mr. O'Donnell also testified that a comparative analysis of the Moody's 24 revealed similarities with Penn Power as to revenue distribution, effective tax rate, and quality of earnings but substantial differences in fuel mix, credit ratings, electric revenues to total revenues, fixed charge coverage, and service territory.

The OCA presented Dr. J. Randall Woolridge as its expert rate of return witness, who recommended a common equity cost rate of 14.8 per cent based primarily on the DCF methodology. He also used the risk premium methodology (14.3-14.8 per cent) as a check. While expressing some reservations concerning the makeup of

the 11 Baa-rated electric utilities for comparative purposes, he did utilize data for this group.

F. *Discounted Cash-flow Methodology*

In developing a cost of equity under the DCF methodology, Mr. Hanley calculated the average dividend yield for his 11 barometer companies for the twelve months ended October 31, 1983, and averaged that figure with the spot dividend yield calculated on November 22, 1983, which produced a mean and median yield of 10.8 per cent. He then adjusted the yield of 10.8 per cent to take into account the periodic payment and expected growth of dividends and developed an adjusted yield of 11.1 per cent.

Mr. Hanley, in the development of his growth factor, reviewed the average five-year compound growth rate in earnings for his barometer group, which is 4.7 per cent. For dividends, this growth rate is 6.7 per cent. In light of these figures and recent commission decisions, Mr. Hanley concluded that a growth rate of 5.5 per cent is appropriate, reasonable, and even conservative. His DCF derived cost rate for equity is 16.6 per cent. In reaching this conclusion, Mr. Hanley also reviewed the recent historic growth of dividends and earnings averaged together and the average of historic and near-term projected growth of dividends. In his opinion, these averages support his judgement.

Trial staff witness O'Donnell applied the same method as the company for calculation of the adjusted dividend yield, giving effect to one-half the expected next-period growth rate. Mr. O'Donnell performed a comparative analysis of dividend yields for periods of twenty, ten, five, and three years, and at September 30, 1983, for Ohio Edison and his three comparison groups.

He then computed a mean yield and one standard deviation in excess of the yield for each, which revealed current dividend yields as consistently greater than one standard deviation in excess of the mean. The results are set forth in the following table:

	Mean Yield + One St. Dev.	*Current Yield (September 30, 1983)*
Ohio Edison Company	11.57	12.30
Barometer Group of Three Electrics	11.20	11.83
Moody's 24	10.30	10.40

Mr. O'Donnell concluded that the market trend is moving from a period of under valuation to proper valuation and concluded that actual yields should be lower in the future.

In developing a growth factor, Mr. O'Donnell first utilized Value Line projected growth rates (1980-82, 1986-88) as derived for the group of Moody's 24, barometer group of three, and Ohio Edison.

Those growth rates are as follows:

	Value Line's 1980-82 to 1986-88	
	DPS (%)	*EPS (%)*
Moody's 24	5.5	5.5
Barometer Group of Three	3.0	4.0
Ohio Edison	2.5	5.0

Mr. O'Donnell analyzed the past ten-year (1973-82) growth rates in earnings and dividends per share for each of his three comparison groups. He further averaged the ten-year historic dividend growth rates with the Value Line dividend growth rate projections to achieve an average dividend per share growth rate. Trial staff contends that the dividend yields and growth rate projections support the reasonableness of the 15.25

per cent equity cost rate recommendation; however, trial staff did not make a specific equity cost rate recommendation under the DCF methodology.

Trial staff states that this particular analysis of both historic and projected growth rates, while not incorporated into the DCF analysis, was done to demonstrate that the results of the use of an historic/projected average do not differ significantly from the use of the projected growth rate alone, as was utilized in Mr. O'Donnell's DCF analysis.

Mr. Woolridge developed the same 10.8 per cent dividend yield recommended by the company but made no further adjustment as did Mr. Hanley.

Dr. Woolridge reviewed fifteen years compounded annual growth rates for the company's barometer group of 11 electric companies. He then selected the mean (4.8 per cent), median (3.7 per cent), and mode (3.7 per cent) of these figures and judgmentally arrived at a growth rate of 4 per cent. He states that this method and result smooth out two aberrationally high recent years, included in Mr. Hanley's calculation, where the compound growth rate was 13.3 per cent and 9.1 per cent, and also recognizes the recent trend toward increasing growth rates. His DCF derived cost rate for common equity is 14.8 per cent.

G. *Risk Premium Methodology*

Mr. Hanley developed an indicated equity cost rate of 16.9 per cent under the risk premium methodology, based upon a cost rate of 11.9 per cent for new Aa-rated bonds, plus a one per cent spread between Aaa-rated bonds and Baa-rated bonds, plus a 4 per cent equity risk premium. Mr. Hanley is of the opinion that his

bond rate includes a real or risk-free return, and an expectation of long-term inflation rates.

Mr. Hanley added one per cent to the basic 11.9 per cent bond rate (based on projections for utility bond rates by Value Line and forty-five economists) to compensate for Penn Power's Baa3 bond rating, and developed a risk premium based on the 1982 Ibbotson and Sinquefield study, *Stocks, Bonds, Bills and Inflation Past and Future* (I&S study).

OCA does not recommend use of the risk premium methodology as a primary determination for an equity cost rate; however, Dr. Woolridge did perform a risk premium analysis as a check on his DCF determination.

Dr. Woolridge used one to one and one-half year U.S. Treasury obligations, rather than utility bonds, as the basis for his riskless investment component, since in his opinion this is the best approximation of a risk-free investment. The riskless rate is in the 9.5 per cent-10 per cent range. Dr. Woolridge then developed an equity risk premium of 4.8 per cent based on his study showing risk premium ranging from 4-5 per cent. He used the high end of the range to account for Penn Power's Baa bond rating. Dr. Woolridge's equity cost rate under the risk premium methodology is an exact confirmation of his DCF calculation of 14.8 per cent.

Mr. O'Donnell utilized Mr. Hanley's 6.2 per cent current real interest rate as being reflective of past, not present, interest rates. Mr. O'Donnell testified that the general consensus of economic forecasting agencies is that inflation will stabilize in the 4-6 per cent range through 1984.

H. *Discussion and Conclusion Re: Cost of Common Equity*

1. *Discounted Cash-flow Methodology*

Mr. Hanley calculated the average dividend yield for his 11 barometer companies for the twelve months ended October 31, 1983, and averaged that figure with the spot dividend yield calculated on November 22, 1983, which produced an indicated yield of 10.8 per cent.[5] We find this yield recommendation acceptable since it is based upon a twelve months' average which tends to smooth any abnormal yields at a particular point in time. We do not fault consideration also of a spot yield, provided the spot yield does not reflect the sole basis for a yield computation.

We do not however agree with Mr. Hanley that the yield factor must be adjusted to take into account the periodic payment and expected growth of dividends. This adjustment is based upon the "Gordon" equation which increases the dividend yield by an estimated amount to reflect the quarterly payment schedule of dividends and for growth in dividends during the first year the stock is held. We agree with Dr. Woolridge that the growth factor in the DCF formula (the "g" factor) incorporates a consideration of growth, and Mr. Hanley's yield adjustment which adds one half the growth rate in dividends in the next twelve months amounts to a double accounting for the next year's growth. Accordingly, we will use a yield factor of 10.8 per cent in our DCF calculation of the equity cost rate.

Turning to the growth factor in the DCF formula, Mr. Hanley recommended a 5.5 per cent factor, which was based upon the average five-year compound growth

[5] The same average yield calculated by OCA's witness Dr. Woolridge.

rate in earnings for his barometer group (4.7 per cent) and a growth rate in dividends (6.7 per cent).

Trial staff witness O'Donnell analyzed earnings and dividends growth rates for his three comparison groups for the past ten years. He then averaged the ten-year historic dividend growth rates with the Value Line dividend growth rate. Dr. Woolridge faults Mr. Hanley's growth recommendation for the reason, inter alia, that he places undue reliance on dividend growth compared to earnings growth. Although we have not consistently relied solely upon earnings growth in the DCF computations, we continue to be of the view that earnings growth should be given primary consideration for the reason that dividends are influenced by pay out decisions, and over the long term, dividends should track earnings. Having reviewed the recommendations of the parties, and giving consideration to the above conclusions regarding dividends, we conclude that a proper growth factor is 4.9 per cent-5 per cent. Thus, under the DCF methodology, we find an indicated equity cost rate of 15.7 per cent-15.8 per cent.

2. *Risk Premium Methodology*

Mr. Hanley based his risk premium calculations upon a cost rate of 11.9 per cent for new Aaa-rated bonds, plus a one per cent spread between Aaa-rated bonds and Baa-rated bonds plus a 4 per cent equity risk premium.

Dr. Woolridge utilized one to one and one-half year U. S. Treasury obligations as representive of a risk-free investment. His risk-free rate is in the range of 9.5 per cent-10 per cent. He recommended use of the upper end of this range to account for Penn Power's lower bond rating. This witness developed an equity risk premium of 4.8 per cent.

Trial staff determined an indicated real interest rate of 4.4 per cent-6.2 per cent, an inflation expectation factor of 4.8 per cent, an equity risk premium of 3.2 per cent, and a one per cent adjustment to reflect Penn Power's lower bond rating.

Mr. Hanley's 11.9 per cent cost for Aaa-rated bonds represents a long-term investment which, in our view, is not truly reflective of a risk-free investment over the period the rates determined in this proceeding will be in effect. On the other hand, we find OCA's recommended risk-free cost rate of 9 per cent-10 per cent to be on the low side for the reason that it does not specifically contain any factor reflective of Penn Power's lower bond rating. We concluded that a risk-free cost of [sic] rate of 11 per cent reflects a proper risk-free rate, after considering the infirmities mentioned in the company's and OCA analysis.

We further conclude that an equity risk premium of 5 per cent is appropriate, being at the upper range of Dr. Woolridge's recommendation. We conclude, that a cost of equity under the risk premium methodology of approximately 16 per cent is reasonable.

We determine a fair and reasonable cost rate for common equity in this proceeding to be in the range of 15.7 per cent, our determination under the DCF methodology, and 16 per cent under the risk premium methodology. For our return calculations, we will use a specific equity cost rate of 15.72 per cent.

3. *Fair Rate of Return*

Following is a summary of our fair rate of return finding for Penn Power:

	Capital Structure (1) %	*Cost Rate* (2) %	*Weighted Cost* (3) %
Debt	51.8	10.25	5.31
Preferred Stock	13.9	9.49	1.32
Common Equity	34.3	15.72	5.39
	100.0		12.02

V. *Revenues*

The company's claimed pro forma revenue levels were based on the future test year. Company witness Pazak described how Penn Power's revenue forecast was developed. The development was explained by the company in its main brief:

"Consistent with commission practice, the estimated future test-year figures were then adjusted to eliminate revenues recovered under Penn Power's levelized energy cost rate (LECR) and under the state tax adjustment clause (STAC).

"Estimated revenues have also been adjusted for residential and commercial customer load growth to reflect sales levels at March 31, 1984. As explained by David M. Headings, senior rate and statistical analyst for the company, this adjustment, which increases operating revenues by $779,800, annualizes the effect of changes both in the number of customers and in the usage of existing customers and was based on the three-year averaging method repeatedly approved by the commission in the past.

"Finally, the company has made an adjustment to annualize, at test-year-end prices and quantities, rental

income to be derived from sales of capacity to Ohio Edison. In its initial filing, Penn Power estimated that during 1984 it would sell to Ohio Edison 74 megawatts from Beaver Valley Unit No. 1 and five megawatts from Sammis Unit No. 7. Based on subsequent information, Mr. Pazak later projected that the company will only sell 49 megawatts of capacity from Beaver Valley Unit No. 1 to its parent. As a result of that revision, future test-year revenues have been reduced by $2,439,000.

"[17]As noted by Mr. Headings, it was not necessary to adjust either industrial or streetlighting revenues."

Initially, the OCA proposed an adjustment to the company's original pro forma operating revenue claim to reflect the reduction from 79 megawatts to 49 megawatts in the amount of capacity estimated to be sold to Ohio Edison. As indicated above, the effect of that change was incorporated in Penn Power's final accounting presentation and, accordingly, the data does not require further revision.

Through the testimony of witness Eckhaus, the OCA also recommends an adjustment to reflect what it considers to be the appropriate rate-making treatment of certain capacity charge revenues associated with the sale of 28 megawatts to General Public Utilities (GPU) and 21 megawatts to Potomac Electric Power Company (PEPCO). The OCA argues that the sale of 49 megawatts to Ohio Edison, as referred to above, is considered to be a firm sale and includes capacity and energy charges. Furthermore, the OCA asserts that the PEPCO and GPU sales are also considered firm sales. While the capacity charge revenues from Ohio Edison sale are reflected in base rates under rent from electric

property, and energy charges are included in the levelized energy cost rate (LECR), both the energy and capacity charges of the PEPCO and GPU sales are credited to the LECR.

The OCA noted that the dissimilar treatment with respect to capacity charges is the result of the settlement of Penn Power's last base rate proceeding at R-821918, where capacity sales to PEPCO and GPU were only contemplated. According to OCA, sales have occurred and proper rate making requires that the capacity charges for the two contracts be recognized in base rates. In the opinion of the OCA, this inclusion of capacity payments in base rates, with the continued reflection of energy charges in the energy cost rates, provides a better balance of the benefit of the sales between ratepayer classes.

The company first observes that the capacity charges are not contractually frozen at the 1984 rate levels, and that it is conceivable that PEPCO and/or GPU will not schedule their full contract entitlements every week of the year due to physical or contractual transmission line limitations. With respect to such limitations, the company states that PEPCO and GPU are not required to make capacity charge payments under such circumstances, while Ohio Edison is obligated to make fixed charge payments.

Finally, Penn Power argues that the OCA's proposed adjustment is inconsistent with its rate design philosophy of encouraging its customers to improve their load factors and, if adopted, would detrimentally affect large industrial users who use a much larger number of kilowatt-hours compared to other customer classes.

In response, the OCA maintains that there is little danger of low estimates since the capacity charges under the PEPCO and GPU contracts increase from year to year. Further, the OCA considers physical or transmission line limitations unlikely to occur. With respect to the detrimental effect on large industrial users, the OCA argues, conversely, that these customers unduly receive most of the cost reductive benefits through the energy cost rate.

The ALJ was not persuaded by the company's arguments that GPU and/or PEPCO might not schedule full contract entitlements. The ALJ considered such a scenario speculative and considered the sales to be firm sales as are the Ohio Edison sales. Further, the ALJ found that a general reduction in base rates will benefit all customers. Then, after noting the company's argument that capacity sales will not remain fixed at the 1984 level, the ALJ reasoned that the OCA could not properly have relied on sales levels after 1984 in this base rate proceeding and instructed the company in its next rate filing to include in its revenue calculations the appropriate level of capacity sales for PEPCO and GPU.

The ALJ recommended that the commission adopt the OCA's adjusted amount for rent from electric property of $11,778,418 (13,352,418–1,574,000) rather than the $10, 912,518 indicated in PPC Exh 1 (Future), second revised, and directed Penn Power to file an amendment to its LECR removing the appropriate amounts from it for the LECR year beginning April 1, 1984.

Penn Power filed an exception to the ALJ's recommendation, and, for the most part, reiterated arguments previously made. However, the company did interject

recent commission action which it considers to be of precedental value. In Pennsylvania Pub. Utility Commission v Pennsylvania Power & Light Co. (1983) 55 PUR4th 185, 237, the company argues that the commission held that the concept of a utility "guaranteeing" savings is inconsistent with fundamental rate-making principles and destroys the "raison d'etre" of the LECR.[6] The OCA, in reply, asserts that the company has confused capacity charges and energy charges since capacity charges have to be made regardless of energy sales except under limited circumstances.

Despite failing to address this issue up to this point in the proceeding, staff filed an exception to the ALJ's adoption of the OCA's proposed adjustment. By crediting GPU and PEPCO capacity charge revenues to base rates, staff notes that the net effect is to reduce the company's retail revenues by $1,574,000.

Staff maintains that current commission policy encourages LECR treatment of all off-system sales by Pennsylvania utilities including capacity charges. We consider staff's interpretation of current commission policy regarding treatment of capacity charges to be on point. As recognized by staff, we accorded LECR treatment to capacity charges in Pennsylvania Pub. Utility Commission v West Penn Power Co. R-811836, July 23, 1982, wherein we stated (p. 6):

"Turning to the proposal of West Penn that the F factor in the ECR be revised to remove from base rates, and include in the ECR, the net revenues received from off-system sales to other electric utilities, we find such proposal to be in the public interest. This commission

[6]At issue was $186 million of energy savings projected to be generated by Susquehanna Unit No. 1.

has, in prior rate proceedings of West Penn, been confronted with the issue of an appropriate level for off-system sales to be used in determining the level of allowable revenues. This decision has of necessity been based upon an evaluation of prior off-system sales, and estimated future sales; and a high degree of judgment was used in determining an appropriate level for these sales. West Penn now proposes to pass through to its customers the actual net revenues it will receive in the future from these sales. This removes the uncertainty which has in the past been associated with this issue, and West Penn's proposal will pass the benefit from these sales directly on to its customers, a proposal which is in the public interest. West Penn's testimony and exhibit, regarding the off-system sales contain estimates of sales in the range of $33.7–$42.3 million in 1983 and $24.5–$33 million in 1984. The company anticipates that these sales will actually be higher; and a substantial amount of these sales are under contract with other electric utilities."

By reflecting actual net revenues from off-system sales in the LECR, we were persuaded that the veil of "uncertainty" surrounding this issue had been removed. In fact, we considered such a proposal to be in the "public interest."

According to the OCA, its proposed adjustment reflects the appropriate rate-making treatment of "certain" capacity charge revenues from GPU and PEPCO off-system sales. The OCA considers these sales to be firm sales.

We have reviewed the pertinent testimony and the actual contracts. While it is certain that capacity payments have been received and will be received by

the company in the future, the evidence presented reveals an "uncertainty" with respect to an appropriate level of sales and attendant capacity charges which will be achieved. As indicated in company witness Pazak's testimony, and the actual contractual language, it is conceivable that GPU and/or PEPCO will be unable to schedule their full contract requirements every week of the year, due to physical or contractual limitations. Furthermore, it has also been established that the GPU and PEPCO capacity charge rates will only apply in 1984 and, thereafter, increase from year to year. The company points out, and we agree, that base rate treatment of these charges may understate or significantly overstate the revenues which will be generated in the future. For these reasons, we consider it appropriate to adopt an approach which eliminates the guesswork involved in estimating off-system sales and capacity charges. The utilization of the ECR mechanism to track these revenues will accomplish the desired result. Finally, we disagree with the OCA's view that the inclusion of these capacity charges in base rates provide a better balance of the benefits between ratepayer classes. Since large industrial users make up a disproportionately higher percentage of the company's sales base, we fail to discern how the OCA's proposal is equitable.

Based on the foregoing, we shall grant the company's exception and adopt, for our rate-making purposes, Penn Power's adjusted future test-year revenue. Accordingly, the OCA's proposed adjustment is hereby rejected.

VI. *Expenses and Taxes*

A. *Operating and Maintenance Expenses*

The operating and maintenance expense level claimed by the company for the twelve months ending

March 31, 1984, is $86,837,275. Various expense claims have been contested by staff and the OCA, which are addressed below.

1. *Salaries, Wages and Fringe Benefits*

a. *Level of Employees*

Penn Power estimated that it would have 1,901 employees on its payroll at March 31, 1984, which represents an anticipated increase of twenty-nine employees, or approximately 1.5 per cent over the experienced historic test-year-end level of 1,872.

Staff recommends a downward adjustment of expenses claimed by the company for employees budgeted but not yet hired in the amount of $386,164, as adjusted for Pennsylvania jurisdictional purposes. According to staff, the proposed adjustment is based on the company's history of budgeting for employees in excess of those actually employed.[7]

Staff's description of witness Kalbarczyk's calculation is contained in its main brief and provides as follows:

"In computing his adjustment, Mr. Kalbarczyk utilized the company employee level of March 31, 1983, of 1,872 which represented 98.47 per cent of the budgeted number of 1,902 for that date. This number exceeded by fourteen the actual number of employees at September 30, 1983, of 1,858, thus allowing the company a margin for seasonal and timing differences associated with employees levels. Mr. Kalbarczyk then applied that percentage to a total of Penn Power wages and

[7]Staff states that the company's answers to interrogatories indicated a past and current trend of failing to reach hiring goals when comparing budgeted to actual numbers for the period March 31, 1981, to March 31, 1983.

salaries for the future test year of $27,773,120, to derive a staff proposed allowance for wages and salaries of $27,337,305, a reduction of $438,815. An additional amount of $70,368 was then added to the above final figure, representing the 16.036 per cent of wages and salaries allocable to employee benefits, to arrive at a total adjustment of $509,183. Mr. Kalbarczyk then applied the company allocation factor for operations and maintenance expenses of 79 per cent to derive his recommended adjustment of $402,255 (as reduced to $386,164 for Pennsylvania jurisdiction purposes)."

In support of this adjustment, staff states that company witness Kauffman acknowledged that actual hiring had lagged behind estimated hiring and that trend continued insofar as the future test year was concerned.

The OCA has presented the same arguments as staff in support of an adjustment and undertook the same process in developing its proposed disallowance. However, while staff witness Kalbarczyk's utilized an actual to budgeted ratio of 98.47 per cent, OGA witness Eckhaus employed a ratio of 97.8 per cent, which was based on an average for the past three years, and thereby arrived at a higher indicated adjustment of approximately $458,200 ($580,000 × 79 per cent).

The company first argues that its failure to achieve past budgeted employee levels does not necessarily suggest that the same will hold true in the future. Further, Penn Power argues that the actual number of employees has continued to grow and the economy has improved. Therefore, the company considers it entirely possible that it will reach the estimated level of 1,901 employees by March 31, 1984.

Finally, the company contends that the methodologies employed by staff and the OCA are flawed in several respects. First, the company contends that it is unrealistic to assume that all employees budgeted but not hired would be compensated at the average wage level of all existing company personnel. Secondly, while the ratios developed by staff witness Kalbarczyk and OCA witness Eckhaus were based on employee levels which included all of the workers at the Bruce Mansfield plant, the payroll figures to which they were applied only reflected the company's proportionate ownership share of the costs attributable to that facility. Thirdly, the company maintains that there is an overlap between these adjustments and certain proposals of staff and the OCA in the area of steam power maintenance expense.

Responding to a staff interrogatory, the company also presented a specific analysis of budgeted versus actual employees at the spot date September 30, 1983. Company witness Kauffman calculated that the expense attributable to budgeted but not as yet hired employees approximated $336,000, after application of the 79 per cent allocation factor.

In the event that an adjustment is deemed appropriate, the company asserts that it should not exceed $272,000, which equals the maximum potential cost savings of $336,000 less the additional expense of $64,000, which is attributable to the higher than anticipated wage increase received by the employees at Beaver Valley Unit No. 1.[8]

In its reply brief, staff argues that its utilization of the 98.42 per cent ratio of actual to budgeted employees

[8]According to the company, it underestimated the wage increase costs which it will incur as a coowner of Beaver Valley Unit No. 1.

accurately considers Penn Power's share of the Bruce Mansfield plant.

The ALJ first dismissed the company's arguments that the number of employees has increased and that given this upward trend and an improving economy the company may reach its budgeted level. The ALJ considered this argument speculative, not supported by any evidence of an improving economy in its service territory, and in conflict with the company's own testimony regarding implementation of a hiring freeze and/or cost cutting measures.

Further, the ALJ found that staff had substantiated its contention that its ratio of 98.42 per cent was derived with or without the Bruce Mansfield plant employees.[9]

Finally, the ALJ determined that the company's cost saving figure of $336,000 cannot be substituted for the adjustments proposed. The ALJ reasoned that the calculation did not take into consideration fringe benefits and the final figure utilized was not projected to the future test-year levels.

In the opinion of the ALJ, staff's adjustment represented an appropriate projection of the company's employment future. Accordingly, the ALJ recommended the adoption of staff's proposed reduction of this expense by $386,164.

The company and the OCA have excepted to the recommendation. It appears that the company has conceded that its actual level of employees will not reach the budgeted level. However, the company opposes the amount of the disallowance recommended by the ALJ.

[9]According to the ALJ, the OCA had not demonstrated similarly that the Bruce Mansfield plant adjustment would produce no impact.

The company has now taken the position that if an adjustment is deemed appropriate, it should not exceed $325,881 (or $312,846 on a Pennsylvania jurisdictional basis), which equals the anticipated cost savings developed by company witness Kauffman ($336,000) plus associated fringe benefits ($53,881) less the additional expense attributable to the higher than anticipated wage increase received by the employees at Beaver Valley Unit No. 1 ($64,000). Moreover, if an adjustment is made to the company's claim for steam power maintenance expense (Section 2, *infra*), Penn Power asserts that the wage expense disallowance must be further reduced by $37,000 ($35,520 on a jurisdictional basis) to eliminate the overlap identified by its witness Pazak.

The OCA submits that in recommending adoption of staff's adjustment, the ALJ failed to accurately reflect the employee cost cutting measures in place for Penn Power.

In deciding this issue, we must first comment on the rationale being employed by the company. After noting that the actual number of employees has continued to grow from March 31, 1981, to March 31, 1983 (1,678 to 1,872), the company asserts that there is no reason to believe that this trend will be reversed. The company has apparently "watered down" its burden of proof on this issue.

Penn Power's claimed labor expense included a projection for additional employees at future test-year-end. In establishing the reasonableness of its claim, it is incumbent upon the company to establish that it will reach its budgeted employee levels at future test-year-end. It is not enough to merely establish that an upward trend exists. This type of rationale ignores the

possibility that the future test-year level of employees is overstated. That is clearly the case here. In fact, the actual number of employees at September 30, 1983, was 1,858, or fourteen employees less than at the beginning of the future test year. Therefore, it is questionable that the actual number of employees on Penn Power's payroll continues to grow.

Turning to the issue of an appropriate adjustment, the company maintains that the adjustment should not exceed $312,846 on a Pennsylvania jurisdictional basis. As indicated previously, the company estimated a cost savings of $336,000 plus associated fringe benefits of $53,881, which equals a total savings of $389,881 or $374,285 on a jurisdictional basis. In comparison, staff's proposed adjustment of $386,164 is slightly higher. However, the company further deducted $64,000 for expenses attributable to the higher than anticipated wage increase received by the employees at Beaver Valley Unit No. 1.

We would first note that the understatement of one expense is not justification for overstating a separate claim. Each individual expense projection should be supported in the record and stand on its own merit without regard to the accurateness of other expense estimates. In contrast to the company's view, we do consider it important to "scrutinize" individual accounts. By tediously examining the component parts that make up the total level of an expense, we believe that a more representative expense level will be reached. Were we to merely engage in an exercise of comparing one claim against another for the purpose of balancing the final results, we would not be focusing on the reasonableness of the claim at issue. In any event, and as staff recognizes, its adjustment may offset the effect of this unanticipated wage increase.

Staff's adjustment was based on an actual employee level of 1,872 as of the beginning of the test year (March 31, 1983), as opposed to the September 30, 1983, level of 1,858 utilized by the company in its analysis. Accordingly, staff has accounted for fourteen more employees in its adjustment, which, we recognize, has not been quantified for comparison.

More importantly, however, we question the validity of the analysis presented by company witness Kauffman for quantifying the cost savings attributable to the lower level of employees hired. As established in the cross-examination of witness Kauffman by staff, there is no evidence in the record which would indicate what entry level wage these new employees would be paid to substantiate the $336,000 cost saving associated with these employees. Quite simply, the record evidence does not support the validity of the company's proposed adjustment, and further, does not act to support a rejection of staff's disallowance.

In conclusion, we agree with the ALJ that staff's recommended adjustment to the company's claimed labor expense properly reflects the company's overstatement of employee levels at future test-year-end. The employee level utilized by staff (1,872) is conservative when compared to the employee level at the midpoint of the future test year (1,858), thereby providing for a margin of error. We consider the OCA's adjustment, which employs the historic 1981-83 ratio of actual to budgeted employees, to be dated and unrepresentative of the company's employment prospects. We shall adopt the ALJ's recommendation and deny all exceptions filed thereto.

b. *Management Salary Increases at March 1, 1987*

Penn Power has budgeted future test-year labor costs to annualize the impact of the company's annual in-

crease for salaried employees anticipated on March 1, 1984. The company estimated that the percentage increase would equal that received during the historic test year; i.e., 8.09 per cent.

The OCA proposes that the management increase totaling $778,000 plus fringe benefits be denied. The OCA considers this annualization to be inappropriate since it is speculative and since it has no bearing on either the economy or recent wage patterns in its service territory. According to the OCA, Penn Power did not attempt to justify the management increase based upon comparable activity in other industries in its service territory, nor on salaries needed to be competitive in its area. Further, the OCA witness Eckhaus testified that the assumed 8.09 per cent increase is not known and measurable and substantially above recent wage increases and forecasts of inflation.

Staff recommends a reduction of $91,971 to the company's claim. Staff witness Jones recommended that the company's projected increase be limited to 7 per cent, consistent with recent commission rulings involving other electric utility management salary requests: Pennsylvania Pub. Utiljty Commission v Pennsylvania Power & Light Co. R-822169 (7.5 per cent requested, 7.5 per cent granted); Pennsylvania Pub. Utility Commission v Metropolitan Edison Co. R-822249 (6.5 per cent requested, 6.5 per cent granted); Pennsylvania Pub. Utility Commission v Pennsylvania Electric Co. R-822250 (6.4 per cent claimed, 5.1 per cent granted).

In view of the discretionary nature of management salary increases and the company's claims of prevailing adverse economic conditions in its service territory, staff considers a 7 per cent management salary increase to be reasonable.

After first acknowledging that the precise amount of the increase cannot be quantified, the company responds to the OCA's proposal by asserting that it is unreasonable to assume that no increase will be granted. The company also argues that projections of expenses are an inherent and integral part of the future test-year rate-making concept.

In its reply brief, the company states that its salary schedule is amongst the lowest, if not the lowest, of any electric utility in the commonwealth. Further, the company maintains that the commission has rejected similar attempts to reduce a utility's claimed wage costs on the basis of "current economic conditions" or the prevailing rate of inflation. Finally, the company asserts that its claim for the projected increase for salaried employees is conservative in comparison to the increase negotiated by its union personnel (9 per cent) and should, therefore, be approved.

In reaching a recommendation, the ALJ first stated that where wage increases are not set forth in a contract, or otherwise not guaranteed, the commission has been willing to adjust salary claims downward. The ALJ cited Pennsylvania Pub. Utility Commission v UGI Corp. R-832331, Jan. 27, 1984, for commission precedent reducing claims for wage and management employee increases where no contractual obligation existed to grant increases. The ALJ also disagreed with the company's reading of the commission's decision in Pennsylvania Pub. Utility Commission v Duquesne Light Co. (1983) 57 Pa PUC 1, 51 PUR4th 198. Again relying on the UGI case, the ALJ stated that the decision in Duquesne did not stand for the proposition that current economic conditions would not be considered in reviewing salary increase expense claims, but merely for

the proposition that poor economic conditions must be set forth on the record. Here, the ALJ concluded that poor economic conditions had been established. In recommending the adoption of the OCA's adjustment which disallows the entire claim, the ALJ further relied on the lack of a contractual obligation.

The company filed an exception to the ALJ's recommendation. Therein, the company asserts that it is unaware of any Pennsylvania utility which has recently failed to grant annual wage increases to its employees. The company submits that it must maintain a competitive salary structure to attract and retain a skilled and qualified workforce regardless of economic conditions. The company also considers the ALJ's reliance on the UGI case to be misplaced.[10]

For the reasons set forth by the ALJ, we shall adopt the ALJ's recommendation which is to disallow the entire claim. We agree in full measure with the ALJ's reading of our decision in UGI which clearly set forth our position that we would consider poor economic conditions in reviewing salary increase expense claims where such conditions were set forth on the record. We further agree with the ALJ that poor economic conditions have been set forth on the record currently before us. In particular, the ALJ noted the high unemployment, industrial closings, cutbacks and wage concessions (Sharon Steel employees—9 per cent). Moreover, we are equally persuaded that the company failed to carry its burden of establishing the reasonableness of

[10]As a final note, Penn Power through an affidavit, indicated the percentage increase actually granted. On March 15, 1984, staff filed a motion to strike the evidence for the reason that it was submitted after the close of record which occurred on December 20, 1983. We find merit with arguments presented by staff in support of its motion and shall, accordingly, grant the motion to strike.

its claim. It appears that the company merely assumed a 8.09 per cent salary increase based on the same percentage increase granted in the historic test year. We need supporting data which establishes the reasonableness of such an increase, especially where there is no contractual obligation. Accordingly, the company's exception is hereby denied.

2. *Steam Power Maintenance Expense (Accounts 510-514)*

For steam power generation maintenance, the company expended $8,195,855 in the historic test year ended March 31, 1983. For pro forma future test-year purposes, Penn Power has claimed expenses of $10,606,450 for the same accounts, which is a 29.4 per cent increase over the historic test-year figure.

Staff recommends that these maintenance expenses be adjusted downward by $655,000. In deriving this adjustment, staff utilized a three-year average of historical data for the years ended March 31, 1982, and 1983, as adjusted for inflation, and the future test year ended March 31, 1984. Staff asserts that its adjustment is representative of a normal level of operations and the three-year averaging methodology was recently supported by the commission in Pennsylvania Pub. Utility Commission v Metropolitan Edison Co. R-822249, Oct. 19, 1983.

Through its witness Eckhaus, the OCA proposes a reduction in the company's claim by $1,969,000. OCA witness Eckhaus selected the level of expense incurred during the historic test year as a "normalized" amount and applied a 4.48 per cent inflation factor to the figure.

In support of its adjustment, the OCA relies heavily on record evidence that the company's recent historical

experience for expenditures for steam power generation do not substantiate the increase. Further, the OCA argues that the record is devoid of any evidence of expenses of a normal, cyclical nature that would justify the increase.

The company has stated that the 29.4 per cent increase was due to additional outage time at the Mansfield plant, a major boiler outage at Sammis Unit No. 7, New Castle No. 4 maintenance repairs, and additional maintenance associated with the air quality control system at the Sammis plant. In support of its 29.4 per cent increase, Penn Power contends that the historic test-year figure was an aberration and clearly represented an abnormally low level of expense for these particular accounts. Once the historic test-year expense figure is eliminated from the analysis, the company submits that its budget estimate is reasonable. According to company witness Pazak, the future test-year claim represents an increase of only 16.3 per cent over the level of expense incurred during the twelve months ended March 31, 1981, or less than the rate of inflation experienced in the intervening three-year period.

The ALJ prefaced her recommendation by first noting that the purpose of a normalizing adjustment is to levelize abnormalities to arrive at a reasonable expense level which reflects actual experience as best as possible. After referencing OCA Exh LSE-2, WP-8, which indicates that on a five-year calendar basis (1978-80) the accounts reflected an expense of $8,215,000 and on a more recent three-year calendar basis (1980-82) the accounts averaged $9,010,000, the ALJ concluded that the data supported staff's normalization adjustment.

The ALJ reasoned that these maintenance expenses are not completely predictable. As a result, the ALJ de-

termined that a comprehensive review of past experience is more valid than a narrow one. Before recommending adoption of staff's normalization method and the resulting disallowance of $655,000, the ALJ concluded that the OCA's method of adjustment was inferior because it only focused on a restricted period of actual experience.

Both the company and the OCA excepted to the ALJ's recommendation. Penn Power argues that steam power maintenance expenses are predictable since an upward trend has been established on the record, whether measured on a test-year or calendar year basis. Furthermore, the company submits that the averaging process, which gives equal weight to an obviously abnormal figure, generates an artificially low result. Finally, the company considers it inappropriate to focus on a single set of accounts since the interrelationship between production plant maintenance activities is thereby ignored. As an example, the company references its claim for nuclear power maintenance expense (Accounts 528-532) which is 17 per cent *less* than the costs incurred during the historic test year. If the commission concludes that its claim for Accounts 510-514 is abnormally high, the company contends that its budgeted level of expense for Accounts 528-532 must be similarly recognized as being abnormally low and in need of upward adjustment.

The OCA criticizes the ALJ's adoption of staff's methodology for the reason that the use of prior years for adjustment purposes runs the risk of including abnormally high dollar maintenance expenditures for bringing major units on line.

For the comprehensive reasons set forth by the ALJ, we shall adopt the ALJ's recommendation which is to

adopt staff's normalizing adjustment and the resulting disallowance of $655,000. We consider it entirely appropriate to give equal weight to the historic test-year expense figure. Although the company contends that this figure represents an abnormally low level of expense for these particular accounts, this argument ignores the possibility that these costs are headed downward. Furthermore, we again fail to discern how a claim for an unrelated expense, which is projected at less than the costs incurred during the historic test year, provides a basis for approving an overstated expense claim.

With respect to the OCA's adjustment, we share the same concern as the ALJ since we are leery of the OCA's strict reliance on the historic test year. Although a possibility exists that the historic test year is representative of future costs to be incurred, the possibility exists that the historic test-year figure is not representative. In vew of the mixed signals that we are receiving from the data, we consider staff's averaging methodology to be the most conservative approach to reaching a normal level for this expense and, therefore, the most appropriate for use in this proceeding.

3. *Tower Painting Costs (Account 571)*

Staff, through it witness Kalbarczyk, proposes a downward adjustment of $345,600 (as allocated for Pennsylvania jurisdiction purposes) to Penn Power's claim of $400,000 for its planned tower circuit painting project for the future test year. As proposed by staff witness Kalbarczyk, the entire amount of the project should be amortized over a ten-year period (the project life of the project), due to the nonrecurring nature of this expense.

The company argues that staff witness Kalbarczyk mistakenly assumed that it would not incur any tower

painting expense during the next ten years. Company witness Pazak summarized what he considered to be the essential flaws in staff witness Kalbarczyk's analysis:

"Mr. Kalbarczyk's recommendation was apparently based on his belief that the company would not incur tower painting costs for another ten years. While it is unlikely that the specific project to which Mr. Kalbarczyk refers will be repeated for another ten years, that line represents only one of 39 tower circuits on the company's transmission system, each of which must be painted and sprayed on a cyclical basis. Moreover, within the past year the company initiated a program under which at least one tower circuit (and probably more) will be painted per year. As a result, the level of expense claimed by the company is not abnormal or nonrecurring, but rather represents a reasonable estimate of the costs which the company will experience annually on an ongoing basis."

Staff submits the company has failed to establish the firmness of its commitment toward this program. In its reply brief, staff attempts to support its position by making the following points:

1. This is the first large scale tower painting project of any kind undertaken by the company;

2. The next circuit to be painted could not be identified with particularity;

3. Budgetary constraints may impede the progress of this project as has been the case in line spraying and clearing projects;

4. The origin of the project at higher management levels was not fully made clear.

Staff also argued in its main brief that the company's cost for the first painting of its longest line, a 345-

kilovolt line, is not a representative estimate to use for future tower painting cost projections.

Although the ALJ agreed that the 345-kilovolt line in issue is atypical, she found that no other cost data had been presented which would have shed doubt on the cost of this line as a basis for projecting maintenance costs. The ALJ did not consider the company's new program of tower painting speculative. Furthermore, the ALJ found that the company had projected costs based on actual experience and, therefore, recommended rejection of staff's proposed adjustment.

In its exception, staff notes that the burden of proof on this expense issue was not upon staff. According to staff, it provided sufficient opposition by establishing that the claimed expense was not adequately supported in the record. Further, staff maintains that amortization recognizes the ongoing nature of such projects while taking into account the less than firm nature of Penn Power's commitment to the project by spreading the cost over the useful life.

The company responds by asserting that amortization is only appropriate where it is shown that the expense item is abnormal and/or nonrecurring, which is not the case here. We agree.

Although we do not consider the supporting data to be overwhelming, we do accept the company's demonstrated commitment to implement an annual tower painting program at the expense level claimed herein. In so doing, we recognize the burden undertaken (39 tower circuits) and the need for regular maintenance of utility facilities.

Staff's opposition to the claim is premised, for the most part, on the firmness of Penn Power's commit-

ment to this program. As support for its adjustment, staff has presented reasons for rejecting the claim which question the viability of such a program. We consider this opposition to be based on pure speculation, which provides an insufficient basis for adjusting Penn Power's claim.

For the reasons set forth by the ALJ, we shall adopt the ALJ's recommendation which is to accept the company's claim and reject staff's proposed adjustment. Therefore, we shall deny the exception filed by staff.

4. *Meter Expenses (Account 586)*

As an expense item Penn Power has claimed $39,000 primarily for installation of a new meter reading system. Staff witness Jones has proposed a reduction of $31,200 (or $31,082 as allocated for Pennsylvania jurisdictional purposes) to the company's claimed meter expenses for the future test year. The company has projected an increase of $143,230 associated with Account 586—meter expenses. This amount represents a 22.3 per cent increase over the level incurred for the historic test year. According to Penn Power witness Pazak, the bulk of this increase can be attributed to a new meter reading system currently being implemented.

Staff witness Jones' proposed adjustment rests on the amortization of $39,000 in start-up costs over a five-year period. Thus, $7,800 would be included in the future test year, and the remaining $31,200 (before jurisdictional allocation) would be amortized over the next four years. Based on his assertion that these start-up costs are nonrecurring in nature, staff witness Jones recommends amortization of those costs over five years in the absence of more specific data on the expected life of the system.

While the company does not disagree with the theory of the proposed adjustment, the company believes that the appropriate amortization period is two years, which approximates the time it will take to completely install the new CIS system. Accordingly, the company argues that any adjustment of Account 586 should not exceed $19,426 ($39,000 total cost ÷ 2 × 99.62 per cent).

The ALJ first took cognizance of company witness Pazak's uncertainty as to the number of functions of the new employees, the expected start-up date of the system, and the expected useful life of the system.

As a result, the ALJ opined that the estimated useful life of the new system is a more appropriate basis for amortizing this one-time expense. The ALJ recommended that staff's adjustment of $31,082 be adopted. No exceptions were filed to the ALJ's recommendations.

For the reasons set forth by the ALJ, we agree with the disposition recommended by the ALJ. Accordingly, we shall adopt staff's downward adjustment of $31,082 to the company's claim.

5. *Uncollectible Accounts Expenses*.

Penn Power has claimed $598,200 for uncollectible accounts expense (Account 904). The company has derived this figure by increasing the historic test-year uncollectible accounts expense of $398,000 by $200,280 for future test-year purposes.

The OCA submits that the increase should be denied in its entirety based on the company's failure to sustain its burden of proof on the claim. In support of this position, OCA witness Eckhaus argued the following:

"The company has increased the historic test-year uncollectible accounts expense of $398,000 by $200,280

to reflect what it calls poor economic conditions, industry shutdowns, continued winter moratorium on shutoffs, reduced collection staff during the summer period, and higher rates in effect for the entire period. Unfortunately, the company has failed to quantify any of these factors and has arbitrarily assigned various dollar amounts to each of the factors considered . . . Therefore, there is no justification or analysis to support the company's proposed adjustment."

According to the OCA, there was no evidence submitted by Penn Power with respect to the relative impact of each of the five reasons for the increase referred to above. Arguing further, the OCA submits that the company's uncollectible estimate was not based on projections of historical patterns or tied to the level of revenues budgeted for the future test year.

The OCA noted that the company attempted to justify the substantial increase through the proof that the company is presently owed approximately $123,000 by four former industrial customers who have declared bankruptcy. With respect to this offer of proof, the OCA contends that the amount of uncollectibles associated with the four industrial customers may not be incremental to prior levels at all. In fact, the OCA maintains that the historical test-year uncollectible accounts expense had been less than it had been for the past several years.

Staff recommended an adjustment which was derived through the development of a write-off rate, representing the total write-offs (residential and commercial) to total revenue from the same classes for years ended March 31, 1981, to March 31, 1983. After applying that write-off rate to total adjusted residential and commer-

cial revenues for the future test-year plus the addition of a normalized level of uncollectibles attributable to industrial revenues, staff has calculated an allowance of $456,165 which equates to a reduction of $141,115 from the company's claim.[11]

Due to the difficulty in quantifying the relationship between poor economic conditions and high levels of uncollectibles, staff considers its methodology from an accounting standpoint. Furthermore, staff argues the effects of the winter shut-off moratorium are predictable from prior experience of the past five years and do not support the claimed 50 per cent increase over the historic test year.

Staff submits that its adjustment of $141,115 is appropriate in that it gives proper consideration to prior year's uncollectibles for all classes of customers. Finally, staff asserts that the evidence indicates that the claimed levels for industrial uncollectibles for the future test year were abnormally high when compared to the recent past, thus making normalization the proper accounting treatment.

The company is of the opinion that the adjustments prepared by staff witness Jones and OCA witness Eckhaus significantly understate the uncollectible expense which it will experience as a result of industrial customer write-offs. Penn Power emphasizes that it is presently owed $123,000 by four former industrial customers which it does not anticipate recovering. In light of existing bankruptcy laws, the company anticipates an increase in industrial terminations.

The ALJ concluded that staff has presented the best basis on which to project future test-year uncollectible

[11]No jurisdictional allocation was necessary.

expense. For the reasons set forth by staff in its main brief, the ALJ recommended adoption of staff's adjustment to reduce the company's uncollectible expense claim by $141,115. Although the company did not take exception to the ALJ's recommendation, the OCA did file an exception.

The OCA considers the ALJ's recommendation to be inconsistent with the evidence presented in this case. According to the OCA, despite finding the lack of any evidence of incremental industrial termination, the ALJ adopted staff's adjustment based upon an incremental increase in such terminations. Although the ALJ's discussion does appear confusing, we believe that the evidence in the record indicates poor economic conditions in the company's service territory which could positively impact industrial terminations. The OCA's argument is shortsighted and inconsistent with its position on the company's claim for management salary increases where the OCA emphasized the poor economic condition of Penn Power's service territory. Therefore, we are of the opinion that the $123,000 amount owed to the company by four former industrial customers should be given some weight in projecting future test-year uncollectible expense.

In furtherance of this objective we have reviewed the method proposed by staff which is to develop an appropriate write-off rate derived from data from prior periods, apply it to *total* expected revenues for the future test year, and normalize the abnormally high level of current industrial terminations. We consider staff's method for projecting a reasonable future test-year uncollectible expense to be the most appropriate for use in this proceeding. Therefore, we shall adopt the ALJ's recommendation which is to adopt the adjustment proposed by staff.

By using the methodology utilized by staff, we will account for the experienced write-off rate, employ current revenue projections for both residential and commercial customers, and moderate the abnormally high level of current industrial terminations through a normalization allowance. We find that these factors provide a comprehensive basis on which to project future test-year uncollectible expense.

6. *Rate Case Expense*

For pro forma purposes, the company has estimated total rate case expense of $314,773. Included within this total claim is $12,067 for the continued ten-year amortization of the company's rate case expense associated with its 1977 rate case at R-77110521 and the normalization of the estimated pro forma current rate case expense over a 12-month period amounting to $302,706.[12]

The OCA does not object to the continued amortization of the past rate case expense, but submits that the commission's practice of equally dividing present rate case expense between ratepayers and investors should be adhered to in this case. The OCA considers the 50–50 sharing practice to be an appropriate balancing of ratepayer and investor interests. Both the OCA and staff argue that the company's filing in this proceeding exemplifies the practices sought to be discouraged by the policy, as originally enunciated in Pennsylvania Pub. Utility Commission v Pennsylvania Power Co. (1982) 55 Pa PUC 552; i.e., repeated and excessive rate filings, a massive overbearing assault of legal and technical experts, operating inefficiencies, and relitigation of mat-

[12]Company witness Kauffman explained that the amount claimed for the 1977 rate case is based on the ten-year reamortization period adopted by the commission at R-811510.

ters consistently decided. The OCA states that the company has once again refused to reflect accrued debt interest and preferred stock dividends for cash working capital purposes, employed four outside consultants, and filed rate cases on a repeated basis. As a result of the annual amortization of the 1977 rate case expense and a 50–50 sharing of current rate case expense, the OCA recommends a disallowance of $142,501 to the company's overall rate case expense claim.

Staff recommends a disallowance of $185,000 in the company's rate case expense claim. Staff witness Jones proposes a 50–50 split or sharing of the current rate case expense between ratepayers and shareholders. According to staff witness Jones, the company has claimed an additional amount of $61,831 as an adjustment to expenses for the amortization of the 1977 rate case ($12,067), and for estimated expenses ($49,764), exclusive of payroll, over the budgeted test-year amount of $320,419. As detailed on Staff Exb LJ-1, this proposed 50–50 split of the company's claim ($320,419 and $49,764) would result in a normalization allowance of $197,000 ($12,067 and $270,183 ÷ 2) or a downward adjustment of the claim by $185,000. Staff shares the view of the OCA that sharing recognizes that both the utility and its investors, as well as ratepayers, benefit from a rate increase. Specifically, investors benefit from increased earnings on their investment while ratepayers are assured of continuing service from a more financially viable company, better able to attract capital. Furthermore, staff argues that the policy decisions supporting the sharing concept, which were set forth in Penn Power's last litigated rate case (R-811510), are fully applicable in this proceeding.

The company notes that this sharing practice which had once been commission policy, has since been aban-

doned.[13] The company also considers its claim to be conservative when compared to rate case expense estimates submitted by other Pennsylvania electric utilities. Finally, Penn Power contends that both the OCA's and staff's recommended adjustments have erroneously included $67,499 of allocated company payroll expense which would have been incurred regardless of any rate increase filing.

Staff counters by asserting that the $67,499 for payroll expense associated with rate case preparation is improperly included in the company's claim where the company's employees are fully compensated apart from any duties involving rate case work. If the company's entire claim is granted, staff contends that the company would be collecting twice for associated payroll expenses.

In the opinion of the ALJ, the 50–50 sharing of rate case expense is a just and reasonable policy. However, the ALJ recognized the recent commission decision in Pennsylvania Pub. Utility Commission v UGI Corp. R-832331, Jan. 27, 1984 and declined to apply a policy of sharing rate case expense on a 50–50 basis between ratepayers and shareholders.

With respect to specific adjustments, the ALJ found merit with staff's argument that the company failed to eliminate $67,499 from rate case expense, as no correlative downward adjustment had been made to Penn Power's wage and salary expense claim. In effect, the

[13]In support, the company has cited the following cases: Pennsylvania Pub. Utility Commission v Philadelphia Electric Co. (1983) 56 PUR4th 637; Pennsylvania Pub. Utility Commission v Equitable Gas Co. (1983) 57 Pa PUC 423, 54 PUR4th 406; Pennsylvania Pub. Utility Commission v Philadelphia Electric Co. (1983) 53 PUR4th 259; Pennsylvania Pub. Utility Commission v Pennsylvania Gas & Water Co. R-822102, April 25, 1983.

ALJ considered this to be a double counting of payroll expense for these employees. Finally, the ALJ acknowledged that no party challenged Penn Power's amortization of its 1977 rate case or its one-year normalization of current rate case expense. The ALJ recommended adoption of the company's claim except for a downward adjustment of $67,499. The OCA and Penn Power have excepted to the ALJ's recommendation.

As an initial response, the company asserts that it is procedurally improper for staff to propose an alternative adjustment in its reply brief. In any event, the company maintains that staff's "double counting" argument is in error.

By way of explanation, the company states that it has claimed $302,706 which represents the estimated cost of this proceeding. However, the company contends, as noted in its response to trial staff Data Request RE-15, that no company payroll is included in the $302,706 figure. According to the company, the $67,499 figure represents budgeted payroll costs which are included in the "test-year estimate" column of p. J1 of Penn Power Exh 1 (Future) as administrative and general expense and which, for accounting purposes, are booked to Account 928 (regulatory commission expense).

The OCA argues, in support of its exception, that an equal sharing of rate case expense is consistent with the commission's decision in Penn Power's last fully litigated rate case at R-811510.

We agree with the ALJ's recommendation to the extent that the ALJ has declined to apply a policy of sharing rate case expense on a 50-50 basis between ratepayers and shareholders. This is consistent with our

recent decisions. Pennsylvania Pub. Utility Commission v UGI Corp. R-832331, Jan. 27, 1984; Pennsylvania Pub. Utility Commission v Peoples Nat. Gas Co. R-832315, Jan. 13, 1983; Pennsylvania Pub. Utility Commission v Equitable Gas Co. (1983) 57 Pa PUC 423, 54 PUR4th 406. Furthermore, when tested against the standard of being a reasonable expense for rate-making purposes, we conclude that the company has met its burden of proof. There is no evidence of record which would indicate that the claim for current rate case expense is excessive.

However, we shall reject the ALJ's recommendation with respect to disallowing $67,499 of the company's current rate case expense claim. As indicated previously, and explained by the company in its exceptions, no company payroll costs have been included in the $302,706 claim for current rate case expense.

Based on the foregoing, we shall grant the exception filed by Penn Power and deny the exception filed by the OCA.

7. *Depreciation Expense*

As discussed under the depreciation reserve section of this opinion and order, trial staff has recommended a reduction of $253,068 to the company's claimed depreciation expense in order to reflect use of the remaining life depreciation methodology. We concur with the trial staff's recommended depreciation expense adjustment as previously discussed and, accordingly, will reduce depreciation expense by $241,680.[15]

[14]As noted by the company in its main brief, the claim for current rate case expense is within the expense range incurred by Penn Power in prior rate proceedings.

[15]See, pp. 602-605, *supra*.

8. *Canceled Nuclear Unit Costs*

In January, 1980, the CAPCO companies announced the cancellation of four nuclear generating stations then under construction, Davis-Besse Units Nos. 2 and 3 at Port Clinton, Ohio, and Erie Units Nos. 1 and 2 at Berlin Heights, Ohio. As explained by Mr. Pazak, the decision to terminate construction was based on a number of considerations, including growing political and regulatory uncertainties arising from the Three Mile Island incident, serious financial constraints of various CAPCO members, and a reduced need for additional future generating capacity.

In prior rate proceedings, consideration of the company's claim for the recovery of the expenses incurred with respect to these four units was deferred pending the outcome of the commission's extensive investigation of the CAPCO construction program at Docket Nos. 1-79070315 and I-79070317. See, e.g., Pennsylvania Pub. Utility Commission v Pennsylvania Power Co. (1982) 55 Pa PUC 552. However, on January 13, 1983, the commission entered its final order in that proceeding and expressly authorized Duquesne Light Company and Penn Power to amortize their respective shares of the cancellation costs in the appropriate rate cases over a period of ten years. Shortly thereafter, the commission allowed Duquesne to begin to recover these costs from its ratepayers. See Pennsylvania Pub. Utility Commission v Duquesne Light Co. (1983) 57 Pa PUC 1, 51 PUR4th 198.

Consistent with those determinations, the company has proposed that its investment, net of taxes, of $9,569,665 be amortized over a ten-year period, which equates to an annual amortization allowance of

$956,967. Mr. Pazak testified that the company's claim in this case is indistinguishable from that reviewed and approved by the commission in the recent Duquesne rate proceeding; i.e., it is based on a similar ten-year amortization period with no return having been requested on the unamortized balance of these costs. As in the Duquesne case, the dollar amount of the company's requested allowance has not been contested.

The OCA urges that the company's proposed amortization should be denied under the provisions of § 1315 of the Public Utility Code, 66 Pa.C.S. § 1315. OCA has presented legal argument similar to that argued in previous cases. As discussed under the land held for future use section of this opinion and order, this commission does not agree with the legal conclusion of the OCA on this issue. Our interpretation is set forth in Pennsylvania Pub. Utility Commission v Duquesne Light Co. (1983) 57 Pa PUC 1, 51-PUR4th 198, wherein we stated:

"In our view the quoted portion of the act is not entirely clear and to our knowledge there is no treatment as an alternative to inclusion in rate base, which this disjunctive phrase is designed to prevent. Consequently, to our reading the quote (sic) disjunctive prohibition is merely designed to prohibit both the inclusion of construction work in progress in rate base and any alternative rate-making action, which some inventive mind might create, as an alternative which would accomplish the same or similar result."

The OCA has not convinced us that our interpretation of § 1315 is incorrect; therefore, we will grant Penn Power an annual amortization allowance of $956,967.

9. *Tax Expense*

a. *Interest Deduction/Interest Synchronization*

The company has proposed a change in the calculation of interest expense for use in deriving the revenue

requirement for rate-making purposes in this case and in future cases. Staff opposes this change through the testimony of witness Robert F. Wilson. OCA has supported staff's position in its main brief.

Penn Power's proposed change and the method proposed to accomplish it are most clearly set forth in Mr. McDaniel's testimony who described the change as follows:

". . . This change relates to the calculation of interest expense which is employed as a reduction of pretax expense. In prior cases, Penn Power had followed the practice of applying the weighted debt component derived from its rate of return study to the net original cost rate base in order to arrive at the proper amount of interest expense for the determination of income taxes. Since the last case at R-821918 [which was in the main concluded by settlement], it has come to our attention that Penn Power's prior practice was in error and not in conformity with current IRS regulations. IRS Regulation § 1.46-6 [adopted in 1979] places certain limitation on the availability of investment tax credit depending upon the rate-making treatment afforded investment tax credit. Penn Power made a timely election under § 46(f)(2) of the IRC and, therefore, deferred investment tax credits may not be deducted from rate base. However, the amortization of previously deferred investment tax credits are fed back to operating income as a reduction of above-the-line income tax expense. In this regard, the company's rate-making treatment has been consistent with the requirements of § 46(f)(2). However, in determining the weighted cost of debt capital, the company's rate of return studies have only considered debt, preferred stock, and common equity as components without regard to investment tax credit.

For rate-making purposes, this practice results in an indirect reduction of income tax expense and, therefore, cost of service because interest expense has been calculated by application of the weighted cost of debt (debt component) to the net original cost rate base, without adjustment. IRS Regulation § 1.46-6(b)(4)(ii) deals with indirect reductions to cost of service or rate base and states in part, 'One type of such an indirect reduction is any rate-making decision in which the credit is treated as operating income (subject to rate making regulation) or as provided by anyone other than the common shareholders.' Penn Power's prior practice has resulted in such an indirect reduction of cost of service."

Trial staff witness Wilson testified that the company's proposed change is erroneous and that the interest expense should be calculated by multiplying the measure of value adopted by the commission by the weighted cost of debt adopted by the commission in its final order. He testified:

"The use of the weighted cost of debt allowed in the rate case and the measure of value allowed, result in the proper interest expense for rate case tax calculation purposes. This methodology has long been accepted by the commission and has been upheld by the courts, because it allows rate case taxes to be consistent with other findings in the rate case.

"The methodology I am recommending also has the effect of allowing higher actual returns on equity than those appearing in commission orders. It also allows a return higher than the overall cost of capital on the combined equity investment plus investment tax credit."

Mr. McDaniels argues that the commission's traditional derivation of interest expense for tax purposes for rate making treats JDIC as capital contributed by all classes of investors, including creditors, and that this results in treating JDIC not as if contributed by equity holders in contravention of IRS regulations, thereby raising the spectre of the loss of JDIC.

Mr. Wilson asserts that JDIC is actually capital contributed at zero cost, and that therefore the commission's traditional interest synchronization approach actually produces a higher rate of return on JDIC than on equity capital and that therefore no indirect effect occurs in contravention of the IRS regulations. He therefore concludes that no JDIC will be lost if the commission continues its traditional method.

Both trial staff and the OCA argue that the only authority which the commission should consider is a formal ruling by the Internal Revenue Service which could support the company's position. Such a ruling has not been issued.

The ALJ concurred with trial staff's analysis that the commission's present approach does in fact comply with all relevent IRS regulations by allowing a rate of return higher than the overall cost of capital. The ALJ also noted that although the regulation at issue here has been on the books since 1979, no Pennsylvania utility has been threatened with the loss of JDIC because of the commission's practice.

Congressional intent as discussed in the preamble to revisions to the Internal Revenue Code § 46, was to reduce the cost to a company of purchasing an asset, not to reduce the effective tax rate of the company over the life of the ass The lower effective tax rate results

from the ratable amortization being deducted from the cost of service.

The commission's methodology provides for the ratable amortization of the investment tax credit over the life of the property which gave rise to the credit. This yearly amortization is used as a credit to reduce the tax expense claimed in a rate case. This reduction to the current federal income tax claim results in a cost-of-service deduction, in the amount of the yearly amortization, calculated using the property's useful life for rate case purposes. The interest expense deduction thus is consistent with the other elements of the case, such as weighted cost of debt used in determining the allowed rate of return and the allowed measure of value.

The gravamen of Penn Power's claim is that the commission methodology is violative of the IRS regulations because it indirectly reduces the company's cost of service by treating eligible property as if financed by common equity. The company bases this assertion on its interpretation of §§ 1.46-6(b)(3)(ii) and 1.46-6(b)(4)(ii), which require that the credit be treated as if it were contributed by common shareholders and that it be allowed to earn a return not less than the overall cost of capital.

We agree with trial staff that this assertion is simply incorrect because it simplistically focuses only on the phrase "as if contributed by common shareholders" and completely ignores the other requirement. In fact, the commission methodology both treats the credit as if it had been contributed by common shareholders *and* the return actually allowed causes no direct or indirect effects upon the investment tax credit which would cause the company to be given a return on the credit less than the overall return allowed.

The commission's methodology also satisfies other relevant federal regulations. Specifically § 1.46-(a)(3) indicates that the credit will be lost to a utility taxpayer if rate base or cost of service is reduced by the credit faster than ratably; i.e., faster than over the life of the property. The method calculating interest expense used by the commission does not cause a greater than ratable reduction of cost of service or rate base.

Although not controlling under the specific matter at issue, we note that our practice of using the allowed weighted debt cost and measure of value to calculate the interest expense has been upheld in several recent appellate court decisions. See: Big Run Teleph. Co. v Pennsylvania Pub. Utility Commission (1982) 68 Cmwlth 296, 449 A2d 86; Carnegie Nat. Gas Co. v Pennsylvania Pub. Utility Commission (1981) 61 Pa Cmwlth 436, 433 A2d 938; and T. W. Phillips Gas Co. v Pennsylvania Pub. Utility Commission (1980) 50 Pa Cmwlth 217, 412 A2d 1118.

In accordance with the foregoing discussion, we conclude that the company had not persuaded us that our treatment of JDIC is violative of IRS regulations. Nor do we agree with the company that our treatment of JDIC will result in the loss of the investment credit.

b. *Normalization of Deferred State Income Taxes*

Penn Power has proposed to normalize its deferred state income taxes.

The OCA contends that the allowance of Penn Power's claim for the normalization of state income tax benefits resulting from accelerated depreciation would represent an unlawful burden placed upon Penn Power's customers in violation of the actual and reasonable tax

doctrine. The overall effect of the OCA's proposal, as stated by OCA witness Eckhaus, would reduced deferred tax expense on the income statement and measures of value by $1.123 million.

The OCA made no separate analysis of this issue in this proceeding, and conceded that it proposed the adjustment essentially for the purpose of preserving the issue which is presently on appeal by the OCA to the Pennsylvania supreme court.

As we stated in Pennsylvania Pub. Utility Commission v Philadelphia Electric Co. (1983) 56 PUR4th 637, 678:

"The company . . . notes the many benefits which the company and its ratepayers obtain as a result of employing normalization accounting. Firstly, normalization provides the true pattern of the company's expense, by recognizing the tax deduction in the same period as the underlying expense. Secondly, normalization increases the current cash flow, which improves the quality of earnings and interest coverage ratios. This, in turn, produces a reduction in the cost of attracting capital and in the amount of capital which must be attracted. Finally, normalization, from a regulatory standpoint, promotes rate stability through levelized tax deductions for rate-making purposes.

The OCA has presented no new or convincing argument which would lead us to change our reasoning fcr approving the normalization of deferred state income taxes. Normalization of taxes was unanimously affirmed by the commonwealth court in Cohen v Pennsylvania Pub. Utility Commission (1983)—Pa Cmwlth —, 463 A2d 1274. The OCA's proposed adjustment is therefore denied.

VII. *Rate Structure and Allocation of Increase*

Public utility rates must enable the utility to recover its cost of providing service and must spread this cost among the utility's customers in a just, reasonably, and nondiscriminatory manner.

Generally, there are two basic determinations to be made in a rate case: (1) how much of an increase is required by the utility and (2) how the increase should be allocated among the different customer classes.

In his "*Principles of Public Utility Rates*" (p. 291) (1961) James C. Bonbright discusses the "criteria of a sound rate structure." The eight items listed by Bonbright are:

"1. The related, 'practical' attributes of simplicity, understandability, and feasibility of allocation.

"2. Freedom from controversies as to proper interpretation.

"3. Effectiveness in yielding total revenue requirements under the fair return standard.

"4. Revenue stability from year to year.

"5. Stability of the rates themselves, with a minimum of unexpected changes seriously adverse to existing customers.

"6. Fairness of the specific rates in the apportionment of total costs of service among the different customers.

"7. Avoidance of 'undue discrimination' in rate relationships.

"8. Efficiency of the rate classes and rate blocks in discouraging wasteful use of service while promoting all justified types and amounts of use:

"(a) In the control of the total amounts of service supplied by the company.

"(b) In the control of the relative uses of alternative types of service."

The ALJ provided a succinct discussion of the various cost-of-service studies and rate design positions of the parties. We shall refer extensively to the ALJ's discussion.

A. *Cost of Service*

In its main brief, the company explained the purpose of a cost-of-service study, which provides as follows:

"The purpose of any cost-of-service study is to allocate plant and expenses among the various classes of service in a manner which reflects each class' relative contribution to the incurrence of those costs. As explained by Mr. Harris, such an analysis typically consists of three basic steps—functionalization, classification and allocation. Costs are first functionalized based upon the function for which they are incurred; i.e., production, transmission, distribution, etc. Each function and/or subfunction is then classified as customer related, demand related, energy related, or some combination of the three. Customer-related costs are those which vary in accordance with the number of customers on the system; demand-related costs vary with the level of kilowatt demand; and energy-related costs vary with the level of kilowat-hour usage. Once costs are so classified, they are allocated to the various customer classes

based on the number of customers, demand, or energy usage of the particular class."

The company has presented a cost-of-service study prepared by Mr. Gerald Harris. The OCA submits that there are three main errors incorporated in the company's study.

1. *Allocation of Power Supply Costs on the Basis of the Company's Average and Excess Methodology.*

The OCA asserts that the allocation of excess power supply costs on the basis of class maximum diversified demand or class noncoincident peaks minus average demand, does not accurately reflect cost-causative class demands. According to OCA, the company allocation is wrong because it is irrelevant to measure class imposed power supply costs. OCA witness Ruback states:

"The sum of each class' noncoincident peak demand has a tenuous relationship with the cost-causative factors which influence the power supply function."

Therefore, OCA witness Ruback has performed and submitted on this record an independent cost-of-service study.

The OCA in its cost-of-service study allocates the excess demand on the basis of customer class contributions to the 12 monthly peaks less average demand. It is the contention of the OCA that the "12 monthly peaks" method more accurately assigns to each class its respective share of costs imposed on the company's system during a year. The OCA notes that the company employed the "12-month coincident peak" method in its most recent FERC allocated cost-of-service study. Further, OCA witness Ruback contends that the "12-

month coincident peak" method considers that production facilities are installed to meet demand from month to month and that monthly peaks have an impact on total capacity since they determine the extent to which generating equipment may be taken out of service for maintenance and repair.

The OCA contends its power supply allocators (12 monthly peaks) more accurately assign to each class its cost-causative share imposed on the company's system over the year.

A comparison of cost-of-service study power allocators between the OCA and the company follows:

Rate Schedule	*OCA*	*Company*
Residential	0.2074	0.2704
WH	0.0260	0.0099
Subtotal	0.2334	0.2803
GS	0.1079	0.0791
GM	0.0873	0.0942
GL	0.5285	0.5051
SL	0.0033	0.0036
Total Ret	0.9604	0.9622
MRS	0.0396	0.0378
Total	1.0000	1.0000

The company contends that the OCA method improperly assigns less costs to the residential customer class and greater costs to the commercial and industrial customer classes. Further, rather than sharing the benefits of diversity to classes, the OCA method assigns benefits to those customer classes whose loads happen to be low at the occurrence of the twelve monthly peak hours in question. It is the position of the company that the "12-month coincident peak" method can and will produce unstable results. Independent of theoretical problems, the company asserts that the OCA allocation factors were developed using data from three separate

and discrete time periods, therefore the factors have no relationship to cost experienced in the historic and future test years, or any other period and have no probative value.

Sharon argues that the OCA's study is designed to shift allocations away from the residential class, and is thus unfair and arbitrary and should be rejected.

Staff did not object to the general usage of the company's cost-of-service study, but indicated that if its own recommended rate design is adopted, new class characteristics may be experienced which will change the primary and secondary customer cost-of-service allocation.

The parties also pointed that the OCA espoused a different method in the last case.

The ALJ recommended acceptance of the company's position because it appeared to be more reflective of cost-causative factors than that proposed by the OCA. According to the ALJ, the company's method has been approved by this commission in previous rate proceedings and is consistent with standards set forth in the NARUC electric utility cost allocation manual. Finally, the ALJ stated that the OCA's factors were developed from three separate discrete time frames which indicates a questionable relationship between the factors and costs experienced or projected.

The OCA filed an exception to the ALJ's recommendation. The OCA argues again that its "12-month coincident peak" method more accurately reflects cost-causative class demands since it is based on class contribution to system peak demands over the course of the whole year. In addition, should the commission have doubts about the data employed in this case, the OCA

contends that the commission should require Penn Power to utilize the "12-month coincident peak" approach in its next case.

2. *Allocation of Distribution System Investment Between Primary and Secondary Functions*

The OCA submits that the company's 60-40 allocation between primary and secondary functions of investment and associated costs is unsupported. Based on the company's allocation factors proposal, the OCA asserts that as the secondary service share of distribution costs increase, customer classes receiving service at secondary voltage experience disproportionately increased costs. A major difficulty, in the opinion of the OCA, is that the 60-40 allocation is based upon a study performed by the company a number of years ago and subsequently lost. A confirming analysis premised upon a review of distribution poles and assigned usage, either secondary or primary, was performed by the company. The OCA alleges that the company's study includes double counting of certain poles and if the double accounting is eliminated, the allocation study would indicate a pole split of 64-36 primary to secondary. Further, the OCA maintains that another problem deals with the allocation of all poles over 30 feet tall, 19 per cent of which have been allocated to secondary use. According to the OCA, the 19 per cent allocation is merely an approximation and is unsupported by any studies.

Although the distribution pole analysis was presented as a proxy for the company's lost study and does approximate the 60-40 split, the OCA contends that this commission should expect a higher level of analysis than the company presented in this proceeding.

The company asserts that, even though the OCA analysis indicates that 64 per cent of the costs are assign-

able to primary service, the OCA's only justification for its 70 per cent recommendation was its contention that the company would devote 19 per cent of its 50-foot distribution poles to secondary service. The OCA witness, the company contends, admitted that he did not know under what circumstances the company would install a 50-foot pole.

The ALJ found merit with the OCA's criticism of the company's 60-40 allocation factor supporting data and studies. According to the ALJ, the company's distribution allocation, premised on a lost study, is unacceptable and unprofessional. However, the ALJ found that the OCA's analysis supports only a 64-36 allocation, not the 70-30 it recommends. The ALJ concluded that the company has clearly failed to meet its burden of proof here.

Therefore, the ALJ recommended the acceptance of a 64-36 primary-secondary allocation based on the OCA's analysis and also recommended that the commission order the company to perform a study in this area for its next rate filing.

3. *Employment of the Modified Zero Intercept Method to Develop the Customer Component of the Distribution System*

Although critical of the modified zero intercept methodology of the company, the OCA alleges that, even if the theory is accepted, the company's method for calculating the minimum distribution grid system is unrelated to the company's distribution system. The zero intercept method assumes a degree of demand component in even the smallest unit of the distribution system. The modified zero intercept method as employed by the company employs embedded labor costs

booked in plant accounts as a surrogate for the zero intercept method results.

OCA witness Ruback indicates that the modified zero intercept method contains two basic weaknesses. The first is that the use of the Handy-Whitman Index, which is regionalized and therefore does not provide an accurate index for a rural service area such as served by Penn Power, produces skewed results. Secondly, the OCA points out that the company did not perform any confirming analyses, but relied solely on the Handy-Whitman Index. The OCA contends that if rate base questions require confirming analysis then rate structure questions require equal confirming analysis.

Furthermore, it is the OCA's contention that there is no identifiable customer-related cost component in a distribution system other than services and meters. According to the OCA, distribution systems are not designed for zero load, but to meet the demands of the area served by the distribution plant. Assigning a customer component to a distribution system is not, in the OCA's opinion, assigning costs to the cost-causative factor. However, the OCA submits that it is reasonable and appropriate to assign a customer component to costs which vary with the number of customers.

With respect to the OCA's position that all distribution costs, other than those associated with meters and services, should be allocated on the basis if demand, and company states that this position has been rejected by this commission in the company's last fully litigated rate proceeding at R-811510, and also at Pennsylvania Pub. Utility Commission v Duquesne Light Co. R-811470; Pennsylvania Pub. Utility Commission v Metropolitan Edison Co. R-822249; and Pennsylvania

Pub. Utility Commission v Pennsylvania Electric Co. R-822250.

Sharon Steel supports the company's cost-of-service study methodology and urges that the company's study be used as a guide for setting rates in this case. However, Sharon's support is qualified because of the manner in which the company's data was used in the preparation of the study. According to Sharon, the study was not presented in terms of actual customer rate classifications, but in an arbitrary grouping apparently used solely for preparing and presenting the results.

Based on past commission practice, the ALJ recommended rejection of the OCA's position and adoption of the company's position. The OCA filed an exception to the ALJ's recommendation.

In support, the OCA argues that regardless of the commission's practice of adopting the use of a minimum distribution grid to develop customer-related costs, the approach put forth by the company has no substantial relationship to its particular service territory. In addition, the OCA submits that there is no relationship per se between the number of customers and the cost of the distribution system. According to the OCA, the cost of Penn Power's system is more a function of geography than the number of customers.

4. *Exceptions of Sharon Steel Corporation*

After analyzing the company's cost-of-service study, Sharon Steel has taken the position that the study grossly understates the rate of return produced by Sharon Steel. These alleged overstatements of costs are set forth below.

a. *ECR Revenues and Expenses*

According to Sharon Steel, the ECR collects revenues on a uniform, average basis while the expenses are in-

curred on a nonuniform basis, chiefly because of line losses related to the service level. As a result, Sharon Steel argues that a mismatch occurs which operates to understate the return provided by the high voltage level customers, such as Sharon Steel, on a total cost-of-service basis.

b. *Voltage Level*

Sharon Steel submits that the higher the voltage level, the lower the cost of service because of lower line losses and lower equipment needs. Therefore, Sharon Steel maintains that Penn Power's combining of the 138-kilovolt and 69-kilovolt customers for cost-of-service purposes operates to overstate the cost and thus understate the return from the 138-kilovolt customers including Sharon.

c. *Power Factor*

Sharon Steel contends that it is more efficient to serve a customer with a higher power factor. According to Sharon Steel, the cost revenue curves prepared by Penn Power to show the effect of its rates were based upon a 90 per cent power factor in contrast to its actual power factor of 99 per cent. Therefore, Sharon Steel asserts that Penn Power's study does not reflect the effect of a leading power factor which supplies reactive power to the system and operates to understate the return of high power factor customers, such as Sharon.

d. *Average Energy Costs*

Sharon Steel states that there is a cost differential in Penn Power's energy cost depending upon whether the energy is supplied at on-peak or off-peak times. Sharon Steel submits that this cost differential is not reflected in the company's cost-of-service study and results in an

overstatement of the cost of serving customers who use a majority of their power off-peak; such as Sharon.

5. *Conclusion*

[18] In Pennsylvania Pub. Utility Commission v Duquesne Light Co. (1983) 57 Pa PUC 1, 51 PUR4th 198, we put the issue of a utility's cost-of-service study in perspective (57 Pa PUC at p. 61, 51 PUR4th at p. 252):

". . . [a] cost-of-service study is one of the most subjective elements in any rate case. The methods used for classifying items of plant and expense between demand, customer, and energy components are far from being an exact science. Cost-of-service studies are more accurately characterized as engineering art. (Emphasis deleted.)

"This commission has historically recognized the cost-of-service study for what it is: a useful tool for testing the reasonableness of the proposed allocation of the revenue requirement. Rarely, if ever, is the revenue requirement allocated strictly on the basis of cost-of-service results. In most instances, and this case is no exception, the revenue allocation is based primarily on other factors such as economic impact and rate continuity with some modification due to cost-of-service considerations."

Our position is still the same as we continue to view a cost-of-service study as merely a useful tool for testing the reasonableness of the proposed allocation of the revenue requirement. See also, Pennsylvania Pub. Utility Commission v Metropolitan Edison Co. R-822249, Oct. 19, 1983; Pennsylvania Pub. Utility Commission v UGI Corp. R-832331, Jan. 27, 1984.

Therefore, the main issue before us is whether or not the company's cost-of-service study is acceptable, tak-

ing into consideration the limited purpose that we shall use it for; that is, as a guide to the reasonableness of the revenue allocation. Based upon the evidence presented here, we conclude that the company's cost-of-service study is acceptable for this limited purpose. The exceptions of the OCA and Sharon Steel are, accordingly, denied.

B. *Rate Design*

1. *Restructuring of Rate Classification*

For use in this proceeding, Penn Power proposes a restructuring of its present customer rate classifications. Specifically, the company proposes the consolidation of existing commercial classes GS, GM, and GL and industrial classes LP and LT into three rate classifications based on level of *demand*. This change, according to company witness Pazak, aligns secondary, primary, and transmission customers experiencing similar load and energy characteristics and eliminates distortions resulting from migration of large transmission voltage customers to primary or secondary designed rates. Inclusion within each class will be determined by the customer's *demand*. Rate GS, for customers with load below 50 kilovolt-amperes, will comprise the largest class in terms of number of customers. Rate GM will be available for customers between 50 and 200 kilovolt-amperes. Rate GL, for customers above 200 kilovolt-amperes, will be the largest class in terms of sales. Staff submits that this proposal should be rejected because it is flawed in several respects and results in an inappropriate revenue allocation.

The crux of staff's recommendation, developed by staff witness Rosenthal, is that the general service rate classes should be aligned by *voltage* level, rather than by *demand*. Thus, staff would combine the three transmission voltages (23 kilovolts, 69 kilovolts, and 138 kilovolts) into one class, the three primary voltages into another class, and have a third class for secondary customers. In particular, staff witness Rosenthal's proposal would provide the following:

(1) Combine the transmission customers on Penn Power's current Rates LT (forty-five customers) and GL (three customers) into new Rate TP (transmission power);

(2) combine the primary customers on company Rates L (sixty-six customers), GM and GL (eighty customers) into new Rate GP (general—primary); and

(3) combine the 13,450 secondary customers now on Rates GS, GM, and GL into new Rates GS (general service).

According to staff, the use of voltage level as a rate class determinant accurately aligns available rate schedules with costs incurred in providing service and costs invested by the customer in taking power. Secondly, staff contends that the company's present and proposed end-use premised rate design suffers from the migration of customers in certain instances. Thirdly, staff contends that its rate design will be easier and less expensive to implement than the company's proposal which for Rate GM would require a change to kilovolt-ampere metering.

After reviewing the blocking and pricing scheme advanced by the company, staff witness Rosenthal made certain recommendations to produce rates which the witness submits will give a good incentive for efficient energy use as well as ensuring an orderly transition to his new rate schedules.

For general service secondary customers (Rate GS), staff witness Rosenthal proposed the following recommendations:

1. Retention of a minimum/customer charge which includes the first three kilowatts of billing demand;

2. A uniform capacity (demand) charge on all demand in excess of the first three kilowatts; and

3. Three energy blocks: first 150 hours use; next 100 hours use; and all use over 250 hours use.

According to staff, this system would provide an incentive for increasing hours use of demand and it would be more equitable to include the first three kilowatt-hours of demand in the minimum/customer charge than to have no minimum.

For primary service customers (Rate GP), staff witness Rosenthal recommends:

1. A uniform capacity charge on all kilovolt-amperes of billing demand; and

2. Energy charges split into three blocks: first 250 hours use; next 200 hours use; and all use over 450 hours.

Staff maintains that the only difference between this rate design and the company's is that the tail block (over 450 hours use) rate is available to all primary customers.

For Rate TP, staff witness Rosenthal, although accepting the company's proposed GL blocking, repriced blocks to assure that the customers at 23 kilovolts or with higher hour usage are providing a reasonable return. Additionally, staff would place a minimal increase

on demand above 80,000 kilovolt-amperes and propose an energy price below current levels for usage above 450 hours use.

Sharon Steel has taken the position that it should receive a rate decrease and that Rate GL should be redesigned to achieve that purpose.

According to Sharon Steel, the company's current and proposed rates do not track cost of service adequately and need to be changed.

The OCA has not taken a full position on this issue. However, to the extent Sharon Steel employs the company's cost of service, the OCA argues that Sharon's suggested rate of return may be overstated.

With respect to staff's proposals, the company first believes that the classification of customers by voltage level is not required. Secondly, the company argues that implementation of staff's recommended rate schedules would require the conversion of 96 Rate GL secondary customers from kilovolt-ampere to kilowatt metering, which would be contrary to the company's philosophy of encouraging its customers to improve their load factors and not be in the ratepayer's best interest. Thirdly, if staff's voltage level rate classifications were adopted, approximately 601 customers would no longer be subject to the 60 per cent ratchet clause which is presently applicable to Rates GM and GL, thereby increasing the risk of revenue instability. Finally, the company opposes staff's recommended design of Rate GS, as it is committed to eliminating the invested demand feature —i.e., no charge for the first three kilowatts of demand —of Rate GS, which under staff's proposal would be re-

tained and made applicable to an additional 601 customers.

The company argues that Sharon Steel's position should be rejected because it is based on average costs which Penn Power contends do not provide an accurate measure of the costs of serving Sharon. Equally, Penn Power asserts that Sharon Steel's recommended remedy could have a disruptive effect on the rate charged to other Rate GL customers.

In reply to Penn Power's statement concerning the conversion of 96 Rate GL—secondary customers from kilovolt-ampere to kilowatt metering, staff submits that such a switch will have no effect on improvement of load factor:

With respect to the company's contention as to the effect of staff's proposal on the demand ratchet, staff suggests an alternative at p. 4 of Staff Statement RAR-1, which would create a large secondary rate and could incorporate that feature. Staff is of the opinion that the ratchet should not be reimposed on the mass of secondary customers of the company. According to staff, the diversity of these customers is sufficient to permit these loads to be unratcheted.

The ALJ determined that Sharon Steel had not met its burden of proof on this issue since it had not adequately quantified and supported its claim. However, the ALJ found merit with Sharon Steel's contention that its analysis of the company's cost of service was adversely affected by the limited information available. After recommending rejection of Sharon's position, the ALJ recommended that the company be directed to furnish the information required by Sharon Steel in its next rate proceeding, in order that the commission may fully consider Sharon's position.

Sharon Steel excepted to the ALJ's recommendation and argued, for the most part, points previously made in brief. However, Sharon Steel additionally argued that it was erroneous for the ALJ to hold that the burden of proof was upon Sharon with respect to the proposed rates.

We agree, as the company argued, that Sharon Steel's calculation is based on average costs and does not provide an accurate measure of the costs to serve Sharon. As a result, we agree with the ALJ that the Sharon Steel has not quantified or supported its claim that the return which *will* be earned by Penn Power from Sharon's service is excessive. To this extent only, we agree with the ALJ's recommendation. Even though the ALJ stated that Sharon did not carry its burden of proof, we more correctly note that Sharon has not persuaded us that it has adequately quantified and supported its claim. Furthermore we shall direct the company to furnish the information required by Sharon. Accordingly, Sharon Steel's exception is denied.

The ALJ also recommended that staff's proposal be rejected. In the opinion of the ALJ, the company's proposal to restructure certain customer classifications based on demand is reasonable and adequately supported. According to the ALJ, the company must construct its system to meet demand and voltage levels are only a subordinate part of meeting demand. After recognizing that staff's proposal will eliminate some costs, the ALJ concluded that other major costs of voltage service and

of meeting demand will remain. While acknowledging that staff's proposal would recognize certain efficiencies of high voltage service, the ALJ reasoned that Penn Power's rates presently recognize these through high voltage discounts. In light of the company's interest in load management and meeting its load demands, the ALJ recommended that the company's proposal be adopted.

Staff has filed an exception to the ALJ's recommendation and first argues that its rate design, by necessity, reflects Penn Power's actual demand costs since its proposal was developed by using the cost data supplied by the company. Further, staff asserts that it has in fact recommended retention of the company's high voltage discounts. Nevertheless, staff submits that this discount cannot be considered a substitute for needed changes in the pricing of the rate blocks.

Finally, staff notes that the ALJ failed to address the problem of customer migration between rate schedules if staff's proposal is adopted. According to staff, the ALJ also failed to address its proposal that the first three kilowatts of billing demand be included in the customer charge for general service customers.

We find merit in staff's proposal that the general service rate classes should be aligned by voltage level, rather than by demand as advanced by the company. As explained by staff, the utilization of voltage level accurately aligns available rate schedules with the attendant costs involved, eliminates the problem of customer migration, and is easier and less expensive to implement.

Consistent with our adoption of staff's proposal to align general service rate classes by voltage level, we

shall adopt staff's rate design proposal for commercial and industrial customers. We agree with staff that this will provide the necessary incentive for efficient energy use. Finally, we will adopt staff's alternative at p. 4 of Staff Statement RAR-1 which will result in the creation of a large secondary rate and incorporate the demand ratchet.

Based on the foregoing, we shall grant staff's exception and adopt its proposals.

2. *Description of Company's Charges on the Bill*

The OCA recommends that the company, in addition to the information currently provided on customer bills, state the following information: customer charge and calculation of the kilowatt-hour charge or, on demand metered customers, the kilowatt-hour per kilowatt charge, both of which can change with level of usage.

The company proposes to notify its customers, on an annual basis of the current residential customer charges and energy charges and to provide a sample calculation of a typical residential bill through a separate bill insert.

The ALJ recommended acceptance of the company's proposal which the ALJ considered similar to an approach accepted in Pennsylvania Pub. Utility Commission v Philadelphia Electric Co. (1983) 56 PUR4th 637, 682, 683. No exceptions were filed to the ALJ's recommendation. Finding the company's proposal reasonable, we shall adopt the ALJ's recommendation.

3. *Late Payment Charges for Customers Taking Service Under Multiple Rate Schedules*

The company proposed an increase to 3 per cent in monthly late payment charge for its GS, GM, and GL

customer rates. Streetlighting service and residential customer classes are subject to a monthly late payment charge of 1.35 per cent.

Staff recommends that the commission should order consistent late payment charges for streetlighting and general service customers.

Sharon Steel contends that the 3 per cent late payment charge, totaling 36 per cent per year, is excessive and unwarranted. Secondly, it argues that the language of the late payment charge is such that the penalty for late payment is the same whether it is one or thirty days late.

The ALJ agreed that the company's proposal of a 3 per cent late payment charge was excessive and that there should be an incentive in the late payment charge to induce customers to make payment sooner than a full month late. Therefore, the ALJ recommended rejection of the company proposal. No exceptions were filed to the ALJ's recommendation.

Staff noted that the company has governmental and municipal customers which take service both under the general service rate as well as the streetlighting rate. To avoid future confusion, staff recommends that the streetlighting and small general service customers late payment charges be set at the same level.

We agree with the ALJ to the extent that the ALJ has found the company's 3 per cent late payment charge excessive. However, we also find staff's recommendation reasonable. Therefore, we shall adopt staff's recommendation and maintain streetlighting late payment charges at 1.35 per cent.

C. *Revenues Allocation*

Staff has proposed the following revenue increase allocation:

Classes	
Residential	*Increase*
	%
Residential	
RS	14.2
WH	3.9
Total	13.5
General Service	
Secondary	12.7
Primary	10.0
Transmission	13.6
Total	12.9
Streetlighting	
SV	2.9
SI	20.2
SM	12.5
Total	13.2
Total	13.1

As indicated above, staff has accepted the company's proposed revenue increase allocation (residential and streetlighting), except to the extent that some shift occurs under general service classes consistent with staff's rate schedule alignment and internal rate design. Consistent with our decision to adopt staff's proposal to align general service rate classes by voltage level and adopt staff's rate design proposal for commercial and industrial customers, we find staff's proposed revenue requirement allocation, in conjunction with the company's cost-of-service study, reasonable and acceptable, as appropriately scaled back to conform to our revenue requirement finding herein. Accordingly, we shall grant staff's exception to the ALJ's failure to adopt its rate design proposals, and, accordingly, adopt staff's proposed revenue allocation.

Since the OCA proposed revenue allocation is premised on its own cost-of-service study, which we have rejected, we shall similarly reject the OCA's increased revenue distribution which is premised upon that cost-of-service study.

VIII. *Conclusion*

In view of the foregoing, we find that Pennsylvania Power Company is entitled to an opportunity to earn income available for return of $48,298,000. This constitutes an increase in annual electric base rate operating revenue of approximately $15,364,000 (excluding state tax adjustment surcharge revenue and energy cost rate revenue), or approximately 77 per cent of the requested base rate increase of $19,890,200. In furtherance of such an objective, Pennsylvania Power Company is authorized to establish rates which will produce 184,186,000, in annual operating revenues, in such a manner more fully described in the ordering paragraphs [omitted herein].

APPENDIX F

Judgment of the Pennsylvania Supreme Court

SUPREME COURT OF PENNSYLVANIA
WESTERN DISTRICT

DAVID M. BARASCH, Consumer Advocate

v.

PENNSYLVANIA PUBLIC UTILITY COMMISSION

Appeal of: EQUITABLE LIFE ASSURANCE SOCIETY, JOSEPH HORNE COMPANY, KAUFMANN'S and GIMBELS

DAVID M. BARASCH Consumer Advocate, Appellant

v.

PENNSYLVANIA PUBLIC UTILITY COMMISSION

No. 33 W. D. Appeal Docket 1983

Appeal from Order of the Commonwealth Court dated June 13, 1985, at No. 553 C.D. 1983, affirming the decision of Pennsylvania Public Utility Commission entered January 28, 1983, at R-821945.

No. 34 W. D. Appeal Docket 1986

Appeal from Order of the Commonwealth Court dated June 13, 1985, at No. 1364 C.D. 1984, affirming the decision of Pennsylvania Public Utility Commission entered April 11, 1984, at R-832409
90 Pa. Cmwlth. 98, 494 A.2d 58 (1985)
ARGUED: March 11, 1987

JUDGMENT

ON CONSIDERATION WHEREOF, it is now here ordered and adjudged by this Court that the judgment of the COMMONWEALTH COURT OF PENNSYLVANIA be, and the same is, hereby REVERSED.

/s/ IRMA T. GARDNER

Irma T. Gardner
Deputy Prothonotary

DATED: October 15, 1987

APPENDIX G

Notice of Appeal

IN THE SUPREME COURT OF PENNSYLVANIA
WESTERN DISTRICT

DAVID M. BARASCH, CONSUMER ADVOCATE v. PENNSYLVANIA PUBLIC UTILITY COMMISSION, APPEAL OF: EQUITABLE LIFE ASSURANCE SOCIETY, JOSEPH HORNE COMPANY, KAUFMANN'S AND GIMBELS	No. 33 W.D. Appeal Docket 1986
DAVID M. BARASCH, CONSUMER ADVOCATE, APPELLANT v. PENNSYLVANIA PUBLIC UTILITY COMMISSION,	No. 34 W.D. Appeal Docket 1986 Consolidated Appeals

NOTICE OF APPEAL TO THE SUPREME COURT OF THE UNITED STATES

Notice is hereby given that Pennsylvania Power Company and Duquesne Light Company, the intervenors in the above-captioned proceeding, hereby appeal to the Supreme Court of the United States from the final judgment of the Supreme Court of Pennsylvania, reversing the judgment of the Commonwealth Court of Pennsylvania, entered herein on October 15, 1987.

This appeal is taken pursuant to 28 U.S.C. § 1257(2).

Respectfully submitted,

/s/ ALAN L. REED

Alan L. Reed
MORGAN, LEWIS & BOCKIUS
2000 One Logan Square
Philadelphia, PA 19103

Attorney for Intervenor
Pennsylvania Power Company

[Filed: Jan. 7, 1987]

APPENDIX H

Excerpts from the CAPCO Investigation
(as printed in the reproduced record before the
Pennsylvania Supreme Court).

BEFORE THE

PENNSYLVANIA PUBLIC UTILITY COMMISSION

Investigation Upon the Commission's Motion into the Delays in the CAPCO Construction Schedule	I-79070315 I-79070317

REPORT OF INVESTIGATION

BEFORE: Joseph P. Matuschak
Administrative Law Judge

I. HISTORY OF THE PROCEEDING

On January 26, 1979, Duquesne Light Company (Duquesne or Company) filed with the Commission a Tariff Supplement to become effective March 27, 1979, proposing changes in rates, rules and regulations calculated to produce $106,614,868 in additional annual revenues, based on levels of business at September 30, 1978.

On February 23, 1979, the Commission ordered an investigation and suspended the proposed rates until October 27, 1979.

By its order of July 12, 1979, the Commission approved a revenue increase in the amount of $58,000,000 for electric service rendered on and after July 15, 1979, based on the adjusted test year ended September 30, 1978, as stipulated to by the major intervenors, in lieu of the $106,614,868 increase that had been proposed by the Company and suspended by the Commission.

At that time, however, simultaneous with the act of approving the rate increase, the Commission instituted an investigation focused on three complex substantive areas that demanded separate investigations, namely: (1) the impact of the extended outage at Beaver Valley Unit No. 1; (2) CAPCO construction delays; and (3) conservation incentives.

In November, 1978, CAPCO announced major delays in its construction schedules of seven large generating units, ranging from 16 to 36 months.[1]

[1]

Unit	Total Capacity	Old Schedule	New Schedule	Delay
Perry #1	1,205	1981	4/31/83	16 months
Beaver Valley #2	833/862	1982	5/1/84	24 months
Perry #2	1,205	1983	4/30/85	22 months
Davis-Besse #2	906	1985	4/1/88	36 months
Erie #1	1,266	1986	4/1/89	36 months
Davis-Besse #3	906	1987	4/1/90	36 months
Erie #2	1,266	1988	4/1/91	36 months

The instant proceeding to determine the impact on rates and service of the delays in the CAPCO construction schedule were assigned to us.

The Commission's order, adopted July 12, 1979, instituting an investigation with respect to Duquesne into the delays in the CAPCO construction schedule states as follows:

> With respect to the CAPCO construction delays, it should first be noted that CAPCO stands for Central Area Power Coordination Group and it is the energy planning group of which Duquesne is a member. In November 1978, CAPCO announced major delays in the construction of seven large electric generating units, ranging from 16 to 18 months. A list of these generating units together with pertinent data relating to them is attached hereto and made a part hereof. Duquesne is a partner in each of these ventures. The extended schedule of construction will increase the cost of those generating units through inflation and through an increased allowance for funds during construction (AFUDC). Further, energy costs will probably be higher as these new base load units will not be on line to serve the customer needs.
>
> We believe that the problem presented by these construction delays merits the Commission's consideration; THEREFORE,
>
> IT IS ORDERED
>
> 1. That a formal investigation is hereby instituted to determine the impact of the CAPCO construction delays upon the rates charged and the service provided by Duquesne Light Company.

In a similar order, adopted July 19, 1979, the Commission instituted a similar investigation with respect

to Pennsylvania Power Company (Penn Power or Company), also a member of CAPCO, which stated, inter alia:

> IT IS ORDERED:
>
> 1. That a formal investigation is hereby instituted to determine the impact of the CAPCO construction delays upon the rates charged and the service provided by Pennsylvania Power Company.

In addition to the Commission's investigations which were docketed at I-790703125 (Duquesne) and I-79070317 (Penn Power), Petitions to Intervene were filed by the Commission Trial Staff, the Office of the Consumer Advocate, the City of Pittsburgh and Mayor Richard S. Caliguiri, the Neighborhood Legal Services Association, United States Steel Corporation, Crucible, Inc, General Motors Corporation, and certain commercial customers, which are owners of buildings, or their agents, located primarily in downtown Pittsburgh (Commercial Complainants).

In response to Petitions for Modification and Reconsideration, the Commission, on November 8, 1979, entered an order clarifying the scope of the Commission's investigations, as follows:

> A thorough evaluation of delays in construction schedules must include an investigation of Duquesne's (Penn Power's) load forecasts, the load forecasts of other CAPCO members, and the local forecasts for the CAPCO system as a whole. A thorough evaluation of the best solutions to construction delays must include the option of stepping-up the schedules of plants under construction, delaying initiation of additional construction, halting construction on some plants, or investing in smaller other fuel plants. Each option must be considered and evaluated in terms of its ultimate impact on Duquesne's (or Penn Power's) customers.

A prehearing conference was held on October 5, 1979. At that time the parties were directed to file statements of issues involved.

In all, twenty-seven (27) days of evidentiary hearings were held between November 20, 1979 and November 18, 1980. The record consists of 3,620 pages of testimony, as well as thousands of pages of Statements and Exhibits.

Duquesne presented the testimony of Mr. Dempler in the area of generation planning, Mr. Atkinson on finances, Messrs. Gilfillan, Grant and Dudt in the area of load forecasting, and finally, Mr. Dunn on operations. On behalf of Penn Power, Mr. Lynn Firestone testified in the area of generation planning, Mr. Owano on financial planning, and Mr. Pazak on load forecasting. For the Office of the Consumer Advocate, Mr. John Stutz testified in the area of load forecasting, and Dr. Richard Rosen in the area of generation planning. In addition, the Companies submitted numerous exhibits in response to written and oral requests of other parties.

The Office of the Consumer Advocate (Consumer Advocate) presented its evidence through two witnesses.

Effective, October 1, 1980, the Commission Trial Staff withdrew its participation in the proceeding.

During the course of the hearings, on January 10 and 11, 1980, the Chief Executive Officers of the CAPCO companies recommended, and on January 22, 1980, the Board of Directors of the various CAPCO companies authorized cancellation of four (4) of the seven (7) nuclear generating units scheduled for construction. The

reasons for the cancellations were explained by the Companies in their news release as follows:

> The political and regulatory uncertainties affecting the future construction of nuclear plants has intensified following the accident at Three Mile Island. Nuclear construction scheduled further in the future carries greater uncertainty of eventual cost. In spite of our convictions regarding nuclear power, this uncertainty has compelled the CAPCO Companies to terminate those nuclear units not yet under actual construction in order to reduce the future risks to our customers and shareholders.

As a result of this decision, the Companies submitted further evidence with respect to the impact of this most recent decision upon the issues in this investigation.

On May 14, 1980, the Companies filed with the Commission a Petition to Terminate the Investigation, stating, in part,

> 13. Prior to the January 22, 1980 cancellation announcement, the parties to the proceeding had not agreed to issue, but rather, while the Companies were submitting testimony on the impact of the cancellation per the Commission Orders, various other parties were alleging an excess capacity, the propriety of continued construction and selection of nuclear fuel. Whether the schedule delays on rates and service as we believe was the Commission's intent or the broader concept of some of the parties as to excess capacity, propriety of construction and selection of fuel, we believe with the cancellation of the four units the purpose and reason for the investigation has terminated. Clearly with the cancellation of these four units there can no longer be any question of excess capacity and if the Commission desires to investigate Penn Power and Duquesne construction program, we respectfully submit that it should be at I.D. 138 which was instituted for

> that purpose and is an open proceeding at which the Companies file annual reports. As to the propriety of construction and selection of fuel we respectfully submit that the Commission has no jurisdiction. This lack of jurisdiction was clearly articulated by Administrative Law Judge Klovekorn in the Philadelphia Electric rate proceeding at R-79060865 in which he held: "It should be noted again that this Commission lacks jurisdiction over the planning and siting of electric generating stations. As a result a utility may plan and construct a generating station such as Limerick without the need for the express approval of this Commission. The first time that the utility must seek this Commission's approval is in the rate proceeding subsequent to its being placed in service . . . (And) this Commission also has no specific jurisdiction also over the selection of the type of fuel used to generate the electricity . . ." (p. 63)
>
> * * *
>
> "It is hornbook law that the Commission is not a superboard of directors managing the affairs of a utility. This Commission was not established for the purpose of telling a utility when to place a generating plant on line, nor is it proper for a quasi-judicial body to work out the ratemaking treatment of a plant, such as Limerick, outside the context of a rate proceeding." (p. 73).
>
> Thus, it would appear that the original allegations of the parties are outside the Commission's jurisdiction and in the event moot by the cancellation of the last four nuclear units.
>
> 14. Furthermore, to continue this investigation is contrary to the public interest. The original premise of the investigation is negated, the ability of the Commission to change the facts is non-existent and the parties would be required.
>
> * * *

CANCELLATION CHARGES

The CAPCO Companies announced on January 23, 1980 the termination of the last four units, i.e., Davis-Besse #2 and #3 and Erie #1 and #2. As was stated to the press by the Chief Executive Officers of the Companies:

> The political and regulatory uncertainties affecting the future construction of nuclear plants has intensified following the accident at Three Mile Island. Nuclear construction scheduled further in the future carries greater uncertainty of eventual cost. In spite of our convictions regarding nuclear power, this uncertainty has compelled the CAPCO companies to terminate those nuclear units not yet under actual construction in order to reduce the future risks to our customers and shareholders.
>
> These decisions are not without risk. Decisions made today affect adequacy of electrical supply in the future. The companies are concerned about the reliability of electric service to their customers in the mid-1980's—particularly by the 1990's.
>
> These concerns are being continually addressed as each company monitors the growth in customer demand in relation to capacity.
> [Duq. Exhibit 13-C at 2]

The Companies request that the cancellation costs relating to the four cancelled nuclear plants be amortized over a ten-year period. Duquesne's investment in those units at December 31, 1979 were $31,115,727. The claim for a ten-year amortization of $3,111,573 per year had been requested.

In regard to the amortization of $56 million dollar cancellation cost requested by Cleveland Electric

Illuminating Company in relating to the same generating plants, the Ohio Commission stated:

> In determining whether these expenditures were prudent, one must bear in mind what is and what is not at issue. No one disputes that the 1973 decision to embark on the construction in question was reasonable as it was based on the best data available. . . Similarly, no one disputes that the decision to terminate construction was reasonable, given the intervening decline in growth expectations and the uncertainties which now attend the construction of nuclear units. Thus the only real question is whether the decision to terminate should have been made sooner.
> [Companies' Reply Brief, p. 125; Re Cleveland Illuminating Company, Case No. 79-537-EL-AIR, mimeo, at 28-29]

The cancellation of the CAPCO four nuclear plants is not an isolated occurrence. In the past several years a number of nuclear units have been cancelled in the United States, including:

Year Unit Cancelled	Unit	Company
1977	Slurry 3	Virginia Elec. & Power
	Slurry 4	Virginia Elec. & Power
	Barton 1	Alabama Power
	Barton 2	Alabama Power
	Douglas Point 1	Potomac Elec. Power
1978	Sundesert 1	San Diego Gas & Elec.
	Sundesert 2	San Diego Gas & Elec.
	South river 1	Carolina P. & L.
	South River 2	Carolina P. & L.
	Haven 2	Wisconsin Elec. Power
	Zimmer 2	Cincinnati Gas & Elec.
	Atlantic 1	Pub. Service Elec. & Gas
	Atlantic 2	Pub. Service Elec. & Gas
	Unnamed Floating 1	Pub. Service Elec. & Gas
	Unnamed Floating 2	Pub. Service Elec. & Gas
	Blue Hills 1	Gulf States Utility
	Blue Hills 2	Gulf States Utility

Year Unit Cancelled	Unit	Company
1979	Greene County 1	Pow. Auth. State of N.Y.
	Palo Verde 4	Arizona Pub. Serv.
	Palo Verde 5	Arizona Pub. Serv.
	Tyrone 1	Northern States Power
	San Joaquin 1	L. A. Dept. of W. & P.
	San Joaquin 2	L. A. Dept. of W. & P.
	NEP 1	New England Power
	NEP 2	New England Power
1980	Davis-Besse 2	Toledo Edison
	Davis-Besse 3	Toledo Edison
	Erie 1	Ohio Edison
	Erie 2	Ohio Edison
	Sterling	Rochester G. & E.
	Jamesport 1	Long Island Lighting
	Jamesport 2	Long Island Lighting
	Haven 1	Wisconsin Elec. Power
	Greenwood 2	Detroit Edison
	Greenwood 3	Detroit Edison

[See Duquesne Exhibit No. AA and Duquesne Light Company's Petition to Terminate]

1981	Carysville	Gulf Power
	Sterling	Rochester Gas & Elec.
	North Anna	Virginia Elec. & Power
	Montague	Connecticut Power & Light
	Koshkonong	

[See 1982 Annual Report Section of Public Utility Law pp. 64-70]

Four possible options, as exercised by various regulatory commissions, are available to the Commission: (1) no amortization or allowance of cancellation costs; (2) amortization of cancellation costs with unamortized portion included in rate base for return; (3) amortization of cancellation costs with unamortized portion not

included in rate base; and (4) amortization of cancellation costs with the exception of AFUDC portion under either (2) or (3).

Initially, the Commission must determine whether the claim for amortization of cancellation costs, in any fashion, should or should not be allowed as a matter of principle.

There is no question that the overwhelming weight of authority from other jurisdictions supports the principle that an expense prudently incurred, even for a project later cancelled or abandoned because of changed conditions, is a proper expense for ratemaking purposes. The write-off through expenses of abandoned generating facilities is widely accepted among state commissions.

The Public Utility Commission of Texas, at Docket No. 2676, January 9, 1979 approved such costs, saying:

> . . . The Examiner does not feel that it is inappropriate for the Commission to allow a utility to recover selected past investment losses from its ratepayers when the circumstances of the investment, weighed carefully, indicate that insulating the shareholders from the losses provides a necessary incentive for the utility to take reasonable investment risks for the benefits of its ratepayers. Clearly, the Commission felt that the Allen's Creek investment warranted such special treatment.

The Federal Energy Regulatory Commission (FERC), at ER77-533 (2/12/79), in allowing Louisiana Power & Light Company to amortize its investment in two cancelled nuclear units know as St. Rosalie of $13,600,000 over five years noted:

> The mere fact that the St. Rosalie project has been abandoned does not prove that L P & L's

> decision to initiate the project was a "mistake" at the time it was made. Rather, it simply resulted from a change of circumstances which could not reasonably have been forseen. (p. 32)

FERC, in permitting New England Power, at ER76-304, et al, by order of 7/19/79 to amortize its $13,150,000 expenditure on Salem Harbor #5 over a five year period, stated (p. 33):

> It is evident that unless security holders are shielded against risk of losses resulting from aborted projects by way of inclusion in cost of service, the cost of capital will be higher to an extent necessary to compensate for the additional risk. Thus, if rate of return is required to be sufficiently high to enable the public utility to attract capital, the risk of such losses must be borne by the ratepayers either directly. (through cost of service) or indirectly. (through rate of return) . . .

The Michigan Public Service Commission, in allowing Consumers Power Company to recover $13.7 million in unrecovered costs associated with the abandoned Quanicassee nuclear facility, said:

> Applicant's decision to commence planning, site acquisition, site improvement and to incur contractual commitments for architectural, engineering and construction work on Quanicassee project was reasonable and prudent in light of Applicant's load-forecasts of the future demands upon its generating system in the 1980's and the need to construct generation facilities to adequately serve its present and future customers and to provide for sufficient reserve capacity for that purpose . . .
>
> Applicant's decisions were reasonable and prudent in light of the demonstrated need to apply whatever capital funding is obtainable to the completion of other generating facilities now in progress . . .

> and which are scheduled for completion prior to the last projected in-service dates of the Quanicassee units.
> [Consumer Power Co., Case No. F-700, mimeo at 5-6 (February 10, 1975)]

In an attempt to balance equitably the responsibility as between investors and consumers in connection with cancellation costs of abandoned projects the Public Utilities Commission of California at Decision No. 90405, June 5, 1979, stated:

> . . . While we are cognizant of the carrying costs of money on hand, for any project or cost not given rate base treatment; on the other hand, we are also concerned about the burden we are placing on the ratepayers to pay for an abandoned project. While the burden on the shareholders is substantial, the burden on the ratepayers is also substantial. We believe load-growth forecasts of the future demands upon its generating system in the 1980's and the need to construct generation facilities to adequately serve its present and future customers and to provide for sufficient reserve capacity for that purpose. In addition, the initiation of the project at that time was reasonable and prudent in view of the potential advantages offered by nuclear generating facilities and the lengthy approval and construction period necessary prior to completion of those facilities.
>
> Applicant's decisions to defer and ultimately cancel the Quanicassee project were reasonable and prudent in view of its revised load growth forecasts, its inability to raise the huge amounts of necessary capital in the marketplace at reasonable cost to continue the project, its deteriorating financial condition . . . and the further rigidity of nuclear licensing requirements thereby extending the projected in-service dates of the project and in-

creasing the enormous costs projected for completion. In addition that adherence to our practice of allowing recovery of abandonment costs form ratepayers while denying rate base treatment, is an equitable solution to a difficult problem. In addition, in denying rate base treatment of the unamortized nonsite costs, we will adopt a five-year amortization period rather than the ten-year period recommended by the Staff and certain other parties.

In *Central Main Power Co. v. Public Utility Commission*, the Maine Supreme Court, at 433 A.2d 331 (ME 1981), affirmed a Commission order which allowed the company to amortize the costs of a cancelled nuclear plant over a five-year period, but denied recovery of AFUDC and denied a return on the unamortized balance. The court held that this constituted a reasonable balancing of the interests of ratepayers and stockholders.

In *Gulf Power Co. v. Cresse*, the Supreme Court of Florida (No. 60, 437 Jan. 28, 1982) affirmed a decision of the Public Service Commission allowing Gulf Power to amortize the costs of its cancelled Carysville generating plant and to include the unamortized balance in rate base.

The New York Public Service Commission ordered that the costs of the cancelled Sterling nuclear plant be amortized and that the plant owners be allowed a return on the unamortized balance [Rochester Gas & Elec. Corp. Case 27794, Opinion 82-1 (Jan. 12, 1982)].

The Virginia State Corporation Commission recently authorized Virginia Electric & Power Company to amortize the costs of its cancelled North Anna 4 nuclear unit over a ten-year period, but refused to permit a return on the unamortized balance, holding that this

would place too great a burden on ratepayers. [Case No. PUE 810025 (Aug. 24, 1981)].

Similar decisions allowing amortization over varying periods and conditions were reached in Missouri [Union Electric Co., Case No. ER 77-154 (Jan. 19, 1977)]; North Carolina [Carolina Power & Light Co., Docket No. E-2, Sub. 264 (Feb. 20, 1976); Virginia Electric and Power Co., Docket No. E-22, Sub. 224 (Aug. 23, 19780)]; Rhode Island [Narragansett Electric Co., Docket No. 744-335 (Oct. 31, 1975)]; Wisconsin [Wisconsin Electric Power, et al, Case 05-CE-3 (2/14/80)]; and South Dakota [Northern States Power, Case No. F-3069 (Dec. 30, 1976)].

There have been, however, a number of decisions where recovery has been disallowed for abandoned projects. The Arizona Corporation Commission, in a rate case refused recovery for costs to Arizona Public Service Company for costs associated with its interest in the cancelled units 4 and 5 of the Palo Verde nuclear projects. The Commission refused any recovery of sunk costs, notwithstanding its Staff's recommendation that a five-year amortization be allowed [Docket No. U-1345, Decision 51009 (May 30, 1980)]. The Commission's decision was affirmed by the Superior Court of Maricopa County on the ground that it did not constitute an abuse of discretion.

In Ohio the Public Utility Commission allowed Cleveland Electric Illuminating Company [CEI] amortization over a ten-year period of its investment of $56 million in the same four terminated nuclear power plants as involved in this proceeding. [Case No. 79-537 EL-AIR] The Supreme Court of Ohio [at 67 Ohio St 2d 153, NE 2d (1981)], however, on statutory

grounds, reversed the Commission rejecting such amortization. Appeal was denied by The United States Supreme Court for want of a properly presented federal question on January 25, 1982 [50 U.S.L.W. 3590].[3]

It must also be determined by the Commission as to whether the 1973 decision to embark on the construction of Davis-Besse #2 and #3 and Erie #1 and #2, and the 1980 decision to cancel the construction of these four nuclear units, were reasonable.

In this connection, we must view the decision to construct these units in the proper time context. It must be remembered that in 1973 the CAPCO load forecast was about 6% per year. In 1973 before the Arab oil embargo, the companies had every reason to believe that the trends experienced in the years since World War II in peak growth would continue. It seemed reasonable at that time to project continued growth for at least the next ten years.

A reserve analysis study reported in July 1973 to the CAPCO Executive Committee concluded that:

a. The CAPCO Group was large enough to sustain (economically) the reserve requirements associated with the largest generating unit available.

[3]The day following the Ohio Supreme Court decision Moody reduced the rating of CEI bonds from Aa to A.

Subsequently, Ohio Edison Company, another affected company, filed application for emergency rate relief. The day after Ohio Edison filed its application for emergency relief, the Commission granted a temporary rate increase in the amount of $90 million on an annualized basis, effective August 1, 1981. All parties (including the Consumers' counsel) stipulated that without emergency relief, the company would be in financial jeopardy. The Commission granted the increase upon its finding that in its absence, Ohio Edison's ability to render service would be impaired or the company would be financially imperiled. [Case No. 81-898-EL-AEM (July 31, 1981)].

b. Potential benefits of better availability of comparatively small generating units were outweighed by the economies of scale.

c. The economic analysis of plans using various sizes of generating units ranging from 400 MW to 1200 MW shows that 1200 MW units were economically superior to smaller sizes for the CAPCO system in the early 1980's.

d. Nuclear fueled generating units were economically preferred for the CAPCO system in the early 1980's.

With respect to the latter, a comparision was made between alternate long range expansion plans using a series of 1200 MW nuclear and a series of 1200 MW coal-fired units. The result of this comparison showed that nuclear units showed a 20% lower percent worth of customer costs over the period 1981-2005 as compared with coal. The preference of nuclear over coal in this study was on the basis of the lowest cost to the customer.

These four units were committed simultaneously due to the need for additional capacity over the projected construction time requirements, the then expected eight to ten year lead time for installing nuclear generating units, the anticipated economies which would be possible by constructing two or more generating units at the same site and the expected benefits, in terms of licensing which would accrue to a multiple commitment of nuclear units.

The evidence clearly supports the conclusion that the decision to embark upon the construction of these four nuclear plants was prudent.

We turn next to the question as to whether these four nuclear plants should have been terminated earlier.

Dr. Rosen contends that as early as November 1977, CAPCO should have realized that these four nuclear units should have been cancelled.

Following the Arab oil embargo and the recession of 1974, many changes and trends in the economy had occurred and the financial constraints associated with the capacity program were becoming obvious. Reviews were conducted and changes in the program were agreed upon as a result of rapidly increasing construction costs, reduction in load demand, and difficulty in raising necessary financing. These reviews resulted in decisions to modify the construction program in 1975, 1977, 1978 and early 1980. As Mr. Firestone testified (prior to the January 1980 cancellations):

> . . . in each of those instances the CAPCO parties were faced with a situation that the construction program that was ongoing was more than they could sustain financially, and therefore some action was necessary. [Tr. at 499]

Studies by CAPCO, however, reaffirmed that nuclear programs were still economically more attractive. It was felt, however, that the construction program could continue with delays to accommodate the financial resources.

The Three Mile Island accident in 1979, in effect, broke the back of construction plans for Davis-Besse #2 and #3 and Erie #1 and #2. As a result of further study and evaluation by the CAPCO Executive Committee, it was determined that as a result of the Three Mile Island accident CAPCO would experience continual re-engineering, re-manufacture of fabricated parts and retrofitting of such construction as may take place, with adverse effects on the cost to the consumer.

CAPCO decided to cancel these last four nuclear plants on which preliminary costs were expended.

The additional requirements placed on nuclear units by the Nuclear Regulatory Commission as a result of the Three Mile Island accident had substantially increased their cost. Construction permits had not been issued for these units. It was not possible, in today's political and regulatcry climate, to determine with any degree of certainty when or if such permits would be granted. Continued construction of these units would require necessary expenditures of capital money with no assurance that such expenditures would result in units which could be licensed to operate.

On the basis of all the evidence, we find that the CAPCO decisions in regard to the Davis-Besse #2 and #3 and Erie #1 and #3 nuclear units, at every stage to their cancellation, were reasonable and prudent.

While this Commission is not bound by the decisions in other jurisdictions as to the amortization of costs in connection with cancelled nuclear units, we are persuaded that the overwhelming weight of such authority, allowing amortization of such sunk costs, is the proper and reasonable course to follow. Accordingly, we recommend that Duquesne and Penn Power be allowed to amortize their portion of such cancellation costs, the amount of which should be determined in appropriate rate cases, over a ten-year period. However, we recommend, as a proper balancing between investor and consumer interests, that the unamortized balance not be included in rate base for a return.

It must be noted that in regard to Duquesne has paid its costs in connection with the cancelled plants for the past eight years, and will continue to do so over the

next ten years. The investors will pick up more than 50% of the associated costs even if the Company's claim is paid in full. The ratepayer will get the full tax effect of the cancellation.

RECOMMENDATION

It is hereby recommended to the Commission:

1. That the Commission's investigation at Docket Nos. I-79070315 and I-79070317 be terminated.

2. That the Commission allow Duquesne Light Company and Pennsylvania Power Company to amortize their respective portions of the cancellation costs relating to Davis-Besse #2 and #3 and Erie #1 and #2, in appropriate rate cases in such amount as therein determined, over a period of ten (10) years with no return on the unamortized portion thereof.

/s/ JOSEPH P. MATUSCHAK
JOSEPH P. MATUSCHAK
Administrative Law Judge

October 15, 1982

APPENDIX I

Order of the Pennsylvania Public Utility Commission Adopting the CAPCO Investigation.

PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg, PA 17120

Public Meeting held January 7, 1983

Commissioners Present:
Susan M. Shanaman, Chairman, dissenting
Michael Johnson, dissenting
James H. Cawley
Linda C. Taliaferro
Clifford L. Jones

Investigation Upon the Commission's Motion into the Delays in the CAPCO Construction Schedule.	I-79070315 I-79070317

O R D E R

By the Commission:

We adopt as our action the Report of Investigation of Administrative Law Judge Matuschak dated October 15, 1982, and that Exceptions be denied; THEREFORE,

It Is Ordered:

1. That the investigations at I-79070315 and I-79070317 be terminated.

2. That Duquesne Light Company and Pennsylvania Power Company be allowed to amortize their respective portions of the cancellation costs relating to Davis-Besse #2 and #3 and Erie #1 and #2, in appropriate rate cases in such amount as therein determined, over a period of ten (10) years with no return on the unamortized portion thereof.

By the Commission,

/s/ Jerry Rich

Jerry Rich
Secretary

(SEAL)
Order Adopted: January 7, 1983
Order Entered: January 13, 1983

APPENDIX J

Documents Relating to FERC
Treatment of Involved Costs.

OHIO EDISON COMPANY
76 SOUTH MAIN STREET, AKRON, OHIO 44308 • 216-384-5296

March 11, 1980

Mr. L. H. Drennan, Jr., Chief Accountant
Federal Energy Regulatory Commission
825 North Capitol Street, N.E.
Washington, D.C. 20426

Dear Mr. Drennan:

In September 1967, the Central Area Power Coordination Group (CAPCO Companies) consisting of Ohio Edison Company, Pennsylvania Power Company, The Cleveland Electric Illuminating Company, Duquesne Light Company and The Toledo Edison Company announced a program for joint development of power generation and transmission facilities. Each of the companies is obligated to pay a share of the costs of any such jointly owned generating facilities in the same proportion as its ownership interest therein. Included in such program are two nuclear units at the Davis-Besse Power Plant site near Port Clinton, Ohio, and two nuclear units at the Erie Power Plant site in Berlin Heights, Ohio. Ohio Edison Company and its wholly owned subsidiary, Pennsylvania Power Company, has an ownership interest of 41.88% in each of these units.

The plans to construct these units were terminated by the CAPCO Companies in January 1980. The political and regulatory uncertainties affecting the future construction of nuclear plants following the Three Mile Island accident, which in turn carries a greater uncertainty of eventual costs, compelled the CAPCO Companies to terminate these nuclear units that were essentially in the design stage in order to reduce the future

costs to our customers and shareowners. The Davis-Besse units were also in an initial construction phase.

Pursuant to Paragraph C of Account 182, Extraordinary Property Losses, of the Uniform System of Accounts prescribed by the Federal Energy Regulatory Commission (FERC) for Public Utilities and Licensees subject to the provisions of the Federal Power Act, we are hereby requesting permission to use Account 182, Extraordinary Property Losses, to record the accumulated construction costs applicable to Davis-Besse Unit No. 2 and No. 3 and Erie Unit No. 1 and No. 2, and any other costs or recoveries which are experienced.

The amount of $85,410,506 is to be debited to Account 182, Extraordinary Property Losses and credited to Account 107, Construction Work in Progress.

Permission will be sought of The Public Utilities Commission of Ohio (PUCO) and FERC to recover these costs in rates. Should such recovery be granted, the Company would amortize them over the period ordered by the PUCO and FERC to Account 407, Amortization of Property Losses. The income tax effects of the losses shall be deferred and amortized over the same period using Accounts 283, 410.1 and 411.1.

Inasmuch as Pennsylvania Power Company is a wholly owned subsidiary of Ohio Edison Company, this request for like treatment is also being made on their behalf in the amount of $14,761,397.

Please advise if you need any further information in order to grant our request.

Sincerely,

/s/ W. B. Marvin
Comptroller

Duquesne Light Company
435 Sixth Avenue
Pittsburgh, Pennsylvania
15219

March 13, 1980

Federal Energy Regulatory Commission
825 North Capital Street, N.E.
Washington, D.C. 20426

Attention: Mr. Kenneth F. Plumb
Secretary

Gentlemen:

Duquesne Light Company ("Duquesne") hereby applies to the Commission for authorization to use Account 182, Extraordinary Property Losses, to record its accumulated construction costs incurred to date, and other costs or recoveries subsequently incurred, resulting from the termination, in January, 1980, by the Companies in the Central Area Power Coordination Group of plans to construct four nuclear generating units. Duquesne's corporate action to terminate construction of these units was taken at a meeting of its Board of Directors on January 22, 1980.

The affected generating units are Units 2 and 3 at the Davis-Besse Nuclear Power Station, near Port Clinton, Ohio, and Units 1 and 2 of the Erie Nuclear Plant Site at Berlin Heights, Ohio. All of the units were in the design stage; the Davis-Besse units were also in an initial construction phase. Duquesne's ownership interest in each unit was 13.74%.

As of December 31, 1979, the costs to be recorded in Account 182 were $31,155,727, representing Duquesne's share of the gross construction costs at that date. Other costs or recoveries subsequently incurred will also be recorded in Account 182.

The Company intends to amortize the costs accumulated in Account 182 to Account 407, Amortization of Property Losses, over a period of 120 months or any different period if ordered by the Pennsylvania Public Utility Commission. Because of a timing difference between book and income tax deductibility, the appropriate deferred tax accounts will be used. The Company will seek approval of this amortization plan from the Pennsylvania Public Utility Commission which also has accounting jurisdiction over the Company and has primary rate making jurisdiction over the Company's rates. Similar approval will be requested from your Commission in the future when a request is made for a change in jurisdictional rates.

Your prompt consideration and approval of this request will be appreciated. Please let us know if additional information is desired.

Very truly yours,

/s/ CHARLES M. ATKINSON
Vice President—Fiscal

OHIO EDISON COMPANY
76 SOUTH MAIN STREET, AKRON, OHIO 44308 • 216-384-5296

March 24, 1980

Mr. L. H. Drennan, Jr., Chief Accountant
Federal Energy Regulatory Commission
825 North Capitol Street, N.E.
Washington, D. C. 20426

Dear Mr. Drennan:

As requested by Mr. Jonas Green in a recent phone conversation, we are furnishing this additional information with respect to the request embodied in my letter dated March 11, 1980 to use Account 182, Extraordinary Property Losses for costs related to termination of construction of four nuclear units.

The Company and Pennsylvania Power Company have incurred, as stated in my original letter, expenditures of $85,410,506 and $14,761,397, respectively, relating to these units. We anticipate that there will be some additional minor charges as yet unbilled and claims by suppliers for cancellation charges, currently undeterminable and subject to negotiation and possible litigation.

Ohio Edison Company and its subsidiary Pennsylvania Power Company do not at present have any rates in effect which includes any portion of the termination costs.

Ohio Edison Company intends to file requests for rate increases in early May 1980 with The Public Utilities Commission of Ohio (PUCO) for retail customers and with the FERC for wholesale customers. We shall ask each to recognize termination costs related to these units and to include in such rates an amortization of

these costs over a reasonable period. A ten-year amortization period will be requested. Amortization would begin with effective dates of the appropriate rate orders. The rates over which the PUCO has jurisdiction could not be put into effect until about March 1981. The wholesale rates over which the FERC has jurisdiction could be put into effect subject to refund 90 days after filing which would be sometime in September 1980. Pennsylvania Power Company will seek consideration of these termination costs in their next request for rate increases with the Pennsylvania Public Utility Commission in 1981 and with the FERC, possibly in late 1980 or early 1981.

Sincerely,

/s/ W. B. MARVIN

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON 20426

IN REPLY REFER TO:
OCA-AS

April 18, 1980

Mr. Charles M. Atkinson
Vice President-Fiscal
Duquesne Light Company
435 Sixth Avenue
Pittsburgh, Pennsylvania 15219

Dear Mr. Atkinson:

We have reviewed your request submitted by letter dated March 13, 1980, for Commission approval to use Account 182, Extraordinary Property Losses, to defer the costs incurred relative to the cancellation of the proposed Units 2 and 3 at the Davis-Besse Nuclear Power Station and Units 1 and 2 at the Erie Nuclear Plant.

Your request to use Account 182 to defer the costs incurred in connection with the four cancelled nuclear units is approved. The costs, amounting to $31,115,727, are to be charged to Account 182 and amortized to Account 407, Amortization of Property Losses, over a ten-year period beginning with the effective date of rates in your next rate filing, but not later than January 1, 1981. The income tax effects of the loss are to be deferred in Account 283, Accumulated Deferred Income Taxes, and amortized to Account 411.1, Provision for Deferred Income Taxes—Credit, Utility Operating Income, concurrent with the amortization of the loss.

Should any gains or recoveries be realized relative to the cancellation of the construction of the proposed Units 2 and 3 at the Davis-Besse Nuclear Power Sta-

tion and Units 1 and 2 at the Erie Nuclear Plant, such amounts shall be utilized to reduce the unamortized amount of the loss.

If additional costs are incurred relative to the cancellation, they may be included in Account 182 and amortized over the remaining period of the original amortization period. In the event that such additional charges are incurred, you shall notify this office as to the nature and amount of the costs.

The entries authorized to record and amortize the loss and the related income tax effects are for accounting purposes only and are in no way to be construed as constituting a final judgment on or an indication of the prudency of the commitments, expenditures or management's decision relative to the planning, construction or cancellation of the plants that would mandate inclusion of the charges in future rate proceedings. In the event that the charges are disallowed in future rate proceedings, before this or any other regulatory body, the unamortized balance of the loss shall be charged to Account 426.5, Other Deductions, in the year of such disallowance.

Sincerely yours,

/s/ L. H. DRENNAN, JR.
Chief Accountant

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON 20425

IN REPLY REFER TO:
OCA-AS

April 28, 1980

Mr. W. B. Marvin
Comptroller
Ohio Edison Company
76 South Main Street
Akron, Ohio 44308

Dear Mr. Marvin:

We have reviewed your request submitted in behalf of Ohio Edison Company and Pennsylvania Power Company by letter dated March 11, 1980, and subsequent letter of March 24, 1980, for Commission approval to use Account 182, Extraordinary Property Losses, to defer the costs incurred relative to the cancellation of the proposed Units 2 and 3 at the Davis-Besse Nuclear Power Station and Units 1 and 2 at the Erie Nuclear Plant.

Your request to use Account 182 to defer the costs, amounting to $85,410,506 for Ohio Edison Company and $14,761,397 for Pennsylvania Power Company, incurred in connection with the four cancelled nuclear units is approved. The amounts for the respective companies shall be charged to Account 182 and amortized to Account 407, Amortization of Property Losses, over a ten-year period, beginning with the effective date of rates in your next rate filings, but not later than January 1, 1981. The income tax effects of the loss are to be deferred in Account 283, Accumulated Deferred Income Taxes—Other, and amortized to Account 411.1, Provision for Deferred Income Taxes—Credit, Utility Oper-

ating Income, concurrent with the amortization of the loss.

Should any gains or recoveries be realized relative to the cancellation of the construction of the proposed Units 2 and 3 at the Davis-Besse Nuclear Power Station and Units 1 and 2 at the Erie Nuclear Plant, such amounts shall be utilized to reduce the unamortized amount of the loss.

If additional costs are incurred relative to the cancellation, they may be included in Account 182 and amortized over the remaining period of the original amortization period. In the event that such additional charges are incurred, you shall notify this office as to the nature and amount of the costs.

The entries authorized to record and amortize the loss and the related income tax effects are for accounting purposes only, and are in no way to be construed as constituting a final judgment on or an indication of the prudency of the commitments, expenditures or management's decisions relative to the planning, construction or cancellation of the plants that would mandate inclusion of the charges in future rate proceedings. In the event that the charges are disallowed in future rate proceedings, before this or any other regulatory body, the unamortized balance of the loss shall be charged to Account 426.5, Other Deductions, in the year of such disallowance.

Sincerely yours,

/s/ L. H. Drennan, Jr.
Chief Accountant

OHIO EDISON COMPANY
76 SOUTH MAIN STREET, AKRON, OHIO 44308 • 216-384-5296

May 13, 1980

Mr. L. H. Drennan, Jr., Chief Accountant
Federal Energy Regulatory Commission
835 North Capitol Street, N.E.
Washington, D. C. 20426

Dear Mr. Drennan:

I have reviewed your authorization dated April 28, 1980 (OCA-AS) approving the requests of Ohio Edison Company and its subsidiary, Pennsylvania Power Company (Penn Power), to defer the costs incurred in connection with four cancelled nuclear units to Account 182 and to amortize the costs to Account 407 over a ten-year period, beginning with the effective date of rates in the companies' next rate filings, but not later than January 1, 1981. We request that you remove the requirement for amortization to begin by January 1, 1981. It is very unlikely that the effective date of rates in either company's rate filings with The Public Utilities Commission of Ohio (PUCO) or the Pennsylvania Public Utility Commission (PPUC) would be prior to January 1, 1981.

On May 7, 1980, Ohio Edison filed an application with the PUCO for a rate increase which includes recovery of the costs of the terminated units. Under Ohio law, requested rates may be collected subject to refund if the PUCO does not make a decision within 275 days after a case is filed. This time lag would peg the expected recovery to begin on or about March 1, 1981. Penn Power had filed a request for an increase in its rates with the PPUC prior to the termination of the

four nuclear units and was unable to include the costs in its current rate application. The PPUC is expected to render its decision on such request on or about July 1, 1980. Thus, Penn Power expects to make application to the PPUC in April 1981 for a rate increase which would include the costs of the terminated units. Penn Power would expect to begin recovering such costs on or about January 1, 1982.

The purpose of deferring such costs and classifying them as an asset is due to the future economic benefit which results from the reasonable assurance of recoverability from customers. This is in accordance with generally accepted accounting principles. The Addendum to Accounting Principles Board Opinion No. 2 states that:

> If a cost incurred by a regulated business during a given period is treated for rate-making purposes by the regulatory authority having jurisdiction as applicable to future revenues, it may be deferred in the balance sheet at the end of the current period and written off in the future period or periods in which the related revenue accrues, even though the cost is of a kind which in a nonregulated business would be written off currently.

Amortizing these costs beginning January 1, 1981, without having received rate treatment, would clearly be inconsistent with the purpose for originally deferring the costs. In addition, amortization before recovery from customers may improperly infer that the costs will not be recoverable, which may have an adverse effect on the perceptions of persons in the securities market where we must frequently compete for funds. I am certain that this is not the FERC's intent and again request that you remove the requirement for amortization to begin no later than January 1, 1981.

Your usual prompt attention will be greatly appreciated.

Sincerely,

/s/ W. B. Marvin
Comptroller

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON 20426

IN REPLY REFER TO:
OCA-AS

June 27, 1980

Mr. W. B. Marvin
Comptroller
Ohio Edison Company
76 South Main Street
Akron, Ohio 44308

Dear Mr. Marvin:

We concur with your request dated May 13, 1980, regarding our April 28, 1980 letter to you. Accordingly, the second sentence of the second paragraph of our letter regarding the loss on the Davis-Besse and Erie Units is amended to read:

> The amounts for the respective companies shall be charged to Account 182 and amortized to Account 407, Amortization of Property Losses, over a ten year period beginning with the date rates in your next rate filing which provides for recovery of the property loss become effective.

Sincerely yours,

/s/ L. H. Drennan, Jr.
Chief Accountant

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON 20426

IN REPLY REFER TO:
OCA-AS

July 10, 1980

Mr. Charles M. Atkinson
Vice President-Fiscal
Duquesne Light Company
435 Sixth Avenue
Pittsburgh, Pennsylvania 15219

Dear Mr. Atkinson:

As a participant in the Davis-Besse Nuclear Power Station Units 2 and 3 and the Erie Nuclear Power Plant Units 1 and 2, which have been cancelled, you were directed to treat the unrecovered costs relative to such units as an extraordinary property loss by our letter to you dated April 18, 1980. Our authorization further directed that amortization of the loss commence "with the effective date of rates in your next rate filing, but not later than January 1, 1981."[1]

We have been requested by Ohio Edison, Pennsylvania Power Company and The Toledo Edison Company to amend our authorization to them regarding the loss by deleting the requirement that amortization commence no later than January 1, 1981. The amendment was requested so as to allow amortization to coincide with rates which would include recovery of the amortization charges. Their requests have been granted.

So as to provide fair and equitable treatment, the second sentence of the second paragraph of our April 18 letter to you is amended to read:

[1]Participants are Ohio Edison Company, Pennsylvania Power Company, Cleveland Electric Illuminating Company, Duquesne Light Company and The Toledo Edison Company. All participants were directed to treat the loss in the same manner.

The amounts shall be charged to Account 182 and amortized to Account 407, Amortization of Property Losses, over a ten year period beginning with the date rates in your next rate filing which provides for recovery of the property loss become effective.

All other provisions of our letter remain in effect.

Sincerely yours,

/s/ L. H. Drennan, Jr.
Chief Accountant

Duquesne Light Company
435 Sixth Avenue
Pittsburgh, Pennsylvania
15219

CHARLES M. ATKINSON
Vice President-Fiscal

May 13, 1982

Federal Energy Regulatory Commission
825 North Capitol Street, N.E.
Washington, D.C. 20426

Attention: Mr. L. H. Drennan, Jr.
Chief Accountant

Dear Mr. Drennan:

In a letter to the Commission dated March 13, 1980, (copy attached) Duquesne Light Company ("Duquesne") requested authorization to use Account 182, Extraordinary Property Losses, to record its accumulated construction costs and other costs related to the termination, in January 1980, of four nuclear generating units then under construction: Davis-Besse Nuclear Power Station Units 2 and 3, and Erie Nuclear Plant Units 1 and 2.

Such authorization was granted in a letter dated April 18, 1980 and a follow-up clarifying letter of July 10, 1980 (copies attached).

Your letter of April 18, 1980 directed that, in the event additional charges are incurred, Duquesne shall notify your office as to the nature and amount of the costs. That provision is the reason for this letter.

In addition to the original construction costs of $31,115,727, there have been minor amounts charged to Account 182 representing subsequent billings by subcontractors. The balance of original construction costs

in Account 182 at March 31, 1982 was $31,447,067. None of the cancellation costs have been amortized to date because the Pennsylvania Public Utility Commission has not ruled on Duquesne's request to recover such amortization through base rates.

Claims against Duquesne made by The Babcock & Wilcox Company, the principal contractor for the four units, were recently settled. The Settlement Agreement calls for a payment by Duquesne to Babcock & Wilcox on or prior to April 30, 1982, in the aggregate amount of $3,091,500 in settlement of the claims with respect to all four units. The Settlement Agreements, however, contain confidentiality clauses requiring that the amount of the settlement not be disclosed to third parties. In light of those clauses, we respectfully request that the Commission make every reasonable attempt to keep the amount of the settlement confidential.

The $3,091,500, when paid to Babcock & Wilcox, will be placed in Account 182 in compliance with the prior approval contained in your April 18, 1980 letter.

Sincerely,

/s/ C. M. Atkinson

PENNSYLVANIA POWER COMPANY

Direct Dial 412-656-5382

September 6, 1983

Mr. Kenneth F. Plumb, Secretary
Federal Energy Regulatory Commission
825 N. Capitol Street, N.E.
Washington, DC 20426

Re: Docket No. ER81-779

Dear Secretary Plumb:

Administrative Law Judge Thomas I. Megan's Initial Decision of June 20, 1983 in the above docket directed Pennsylvania Power Company to file with the Commission details of the costs of cancellation of four nuclear units (Initial Decision, mimeo pp. 24-25). Enclosed are 14 copies of the details of such costs.

Copies of this filing are being provided to all parties in this docket.

Sincerely,

/c/ Stephen L. Feld

Stephen L. Feld
Attorney

PENNSYLVANIA POWER COMPANY

Total Expenditures Incurred on Cancellation of Proposed Erie Nuclear Units 1 & 2 and D. Besse Nuclear Units 2 & 3 as reflected in Account 182, Extraordinary Property Losses

	Erie #1	Erie #2	DB #2	DB #3	Total
As at December 31, 1980					
Direct Cost	(1) 3,997,844	(1) 1,937,628	(2) 4,317,723	2,045,886	12,299,081
AFUDC	670,615	464,633	715,394	368,453 (3)	2,219,095
Other Costs	—	100	3,238	3,236	6,574
As at 12/31/80	4,668,459	2,402,361	5,036,355	2,417,575	14,524,750
January 1, 1981 through August 31, 1983					
Direct Cost	615,461	49,973	895,764	15,680 (4)	1,576,878
Total Costs as at August 31, 1983	5,283,920	2,452,334	5,932,119	2,433,255	16,101,628

NOTES: (1)—See Exhibit 1
(2)—See Exhibit 2
(3)—AFUDC capitalized as of December, 1979.
(4)—See Exhibit 3

Exhibit 1

Erie Nuclear Units 1 and 2 Total Expenditures as at December 31, 1980

Vendor	Erie Nuclear Unit 1	Erie Nuclear Unit 2	Purpose
Commonwealth & Associates	20,216,448	20,315,353	Outside Engineering Services
Gilbert & Associates	621,855	621,856	Outside Engineering Services
Townsend & Bottum	2,887,763	2,830,546	Pre-Construction Eng. & Consultants
General Atomic	1,450,000	1,450,000	Preliminary N.S.S.
Babcock & Wilcox	29,779,236	1,448,623	Progress Payments N.S.S. System
Dr. Frank O'Hara	1,750	1,750	Consultant
General Electric Company	3,188,540	—	Progress Payment—Turbogenerator System
Westinghouse	15,207	15,207	Design Revision Study
Southwest Research	35,311	35,311	Consultants
C. A. Accounting Services	103,672	103,638	Commonwealth Accounting Services
Tera Corporation	49,157	49,157	Consultants
Purolator Corporation	2,618	2,579	Courier Service
Toledo Edison Company	4,275	4,248	Engineering
Shaw, Pittman, Potts & Trowbridge	271,472	279,375	Licensing & siting legal fees
Proton Consultants	28,082	28,082	Consultants
Fincum-Marcini	3,972	3,972	Court Reporters
E.D.S. Nuclear	95,850	—	Consultants
Pickard, Lowe & Gerrick	58,692	47,697	Licensing Attorneys
National Economic Research Assoc.	158,033	158,033	Consultants
NUS Licensing	72,853	72,853	Licensing Information
Southern Nuclear	8,500	—	Consultants
State of Ohio	60,000	60,000	Building Permit
Winthrop, Stimson, Putnam & Roberts	68,775	68,775	Legal Consultants
General Physics Corporation	5,079	5,079	Consultants
Cleveland Electric Illuminating	4,078	4,078	Engineering
N.R.C.	62,500	62,500	Nuclear Regulatory Commission
Ohio Siting Commission	66,000	66,000	Siting Permit
S. M. Staller Corp.	36,262	36,262	Consultants
Ohio Edison Company	4,306,331	3,085,088	Eng. & Supv., A&G Costs, Other out of pocket Exp.
Total	63,662,311	30,856,062	

NOTE: Above costs represent total 100% project costs, Penn Power proportionate share is 6.28%.

Exhibit 2

Davis-Besse Units 2 and 3
Total Expenditures as at December 31, 1980

Vendor	Davis-Besse Unit 2	Davis-Besse Unit 3	Purpose
A. Bentley & Sons	8,573	8,573	Surveying and dozer work for drilling
Chicago Bridge & Iron	1,668,604	155,885	Containment vessel
Bechtel Power Corp.	16,847,052	16,837,183	Architect and engineering service
Toledo Edison Company	14,491,390	13,795,375	Support services construction
NUS Corporation	396,472	393,393	Technical services—licensing
Fuller, Henry, Hodge & Snyder	150,584	150,224	Legal services
Shaw, Pittman, Potts & Trowbridge	44,215	44,216	Legal consulting service
Woodward—Clyde	1,378,794	1,354,435	Geotechnical consulting service
Value Engineering	198,199	198,199	Develop nuclear QA. prog.
Duane & Kathleen Braugh	55,122	55,123	61 acres of land
Pickard-Lowe & Assoc.	11,419	11,419	Consulting service
Dames & Moore	72,961	72,962	Consulting service AEC questions
National Economic Research	18,918	18,919	Consulting licensing activity
Andrus Survey Co.	1,219	1,219	Survey Brough property
G. M. Barton Survey	7,673	—	Survey D/B 2 & 3
Maumee Valley Silkscreen	662	661	Screen print OPSC application
NUS Corporation	17,555	17,554	Assistance to obtain certificate
NUS Corporation	183,611	—	On-site meteorological system
Monarch Printing	14,609	14,609	Printing & binding service
Treasurer, State of Ohio	18,239	17,505	Sales Tax
Babcock & Wilcox	33,499,737	—	Nuclear steam supply system
Glenn Graffice	1,217	1,217	Core drilling of test holes
Aerial Surveys	1,250	1,250	Topographical mapping
Sussman Asbestos	15,000	—	Office & warehouse bldg.
United Engineers & Constructors	8,619,922	8,585,473	Constructors
Interpace	659,925	248,873	Circulating water pipe (concrete)
Can Tax c/o Meyers	30,817	30,817	Sewage treatment plant
Continental Boiler Works	304,733	304,733	Welded steel circ. water pipe
Arthur Andersen & Co.	158,602	158,602	Project management study

Vendor	Davis-Besse Unit 2	Davis-Besse Unit 3	Purpose
Richmond Engineering	7,836	7,836	Engineering—6 tanks
Hardy & Dischinger	11,288	—	Fire protection equipment
Science Applications	55,011	55,011	Quality assurance service
Energy Controls	5,018	—	Vertical duplex sump pump
Mr. Charles McLain	9,050	9,050	Management services
Vann Loon Industries	3,863	3,863	Fire hydrants & access.
Bingham—Willamette	10,549	10,549	Contaminant spray pump 7 meter
Richmond Engineering	29,971	29,971	Misc. nuclear tanks
Nooter Corporation	15,125	15,125	Stainless steel liner plates
HPD Incorporated	17,500	17,500	Fabricate degasifiers
Marsh & McLennan	6,285	6,285	Builders risk insurance
Quickborner Team, Inc.	7,700	—	Plan administration building
Ohio Citizens Trust Co.	7,938	7,938	Interest—advanced fund
Ohio Citizens Trust Co.	232,600	232,600	Lease—concrete batch plant
Hardy & Dischinger	28,847	28,847	Yard loop fire protection equipment
Toledo Building Service	9,488	9,487	Janitorial service
Xerox Corporation	2,192	2,192	Maintenance 3 machines
Lee Storage Company	2,258	2,258	Move to COB
Wm. Ferrel, Inc.	14,863	8,703	Site maintenance & misc. site work
Bradwell	19,653	19,372	Maintenance COB
Norfolk & Western	880	840	Freight—Interpace pipe.
Treasurer, State of Ohio	54,360	54,360	OPSC—application fee
Arthur Andersen	47,293	47,293	Audit
Atomic Energy Commission	62,500	62,500	Construction fee
Cleveland Electric Illuminating	239,129	239,128	Engineering support & legal charges
NUS Corporation	4,345	4,344	Tech. service—add D/B 2 & 3
Monarch Printing	29,658	29,657	Print maps & etc. OPSC
Ohio Dept. of Transportation	1,000	—	Maintenance of traffic light
Gould Pumps	15,919	15,919	Cooling Water Pumps
Pressure Products	5,920	5,920	Waste Gas Compressors
Struthers—Wells	4,553	4,553	Heat Exchangers
Atlas Industrial	5,452	5,452	Borated Water Heaters and Coolers
Worthington Standard	13,490	13,490	Misc. Pumps

Exhibit 2

Davis-Besse Units 2 and 3
Total Expenditures as at
December 31, 1980

Vendor	Davis-Besse Unit 2	Davis-Besse Unit 3	Purpose
Salvage	(111,650)	(111,650)	
Other misc. vendors under $1,000 ea.	3,035	2,957	
Total Joint Project Cost	79,749,993	43,319,769	
Less Common & Shared Facilities in Service	10,999,635	10,738,768	
Termination Costs	68,750,358	32,581,001	

NOTE: Above costs represent total 100% project costs, Penn Power proportionate share is 6.28%.

Exhibit 3

DIRECT COSTS
January 1, 1981 through August 31, 1983

A. ERIE UNITS 1 AND 2	
Babcock & Wilcox Settlement (1)	$ 502,400
Townsend and Bottum, Inc., Charge (2)	62,800
Babcock & Wilcox (Storage of reactor coolant pump motors)	10,550
345 kV line costs (engineering & siting fees)	82,536
Miscellaneous	7,148
B. DAVIS-BESSE UNITS 2 AND 3	
Babcock & Wilcox Settlement (3)	910,600
Chicago Bridge & Iron Settlement (4)	47,100
Sale of tubing (Credit 7/83)	(32,485)
Sale of Common Facilities to Toledo Edison Co.	(5,508)
Miscellaneous Charges and Credits	(8,263)
TOTAL	$1,576,878

(1) See Attached Exhibit 4
(2) See Attached Exhibit 5
(3) See Attached Exhibit 6
(4) See Attached Exhibit 7

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners:

Raymond J. O'Connor, Chairman;
Georgiana Sheldon, J. David Hughes,
A. G. Sousa and Oliver G. Richard III.

Pennsylvania Power Company	**Docket No. ER81-779-005 (Phase I)**

OPINION NO. 211

OPINION AND ORDER AFFIRMING AND MODIFYING INITIAL DECISION

(Issued March 22, 1984)

This opinion affirms on all but one issue an initial decision issued in the above docket on June 20, 1983. The decision is modified only to the extent that we find a 16.37 percent rate of return on common equity to be appropriate.

The proceeding involves a two-level rate increase to five wholesale, full requirements customers of Pennsylvania Power Company (Penn Power or Company). The affected customers are the Boroughs of Ellwood City, Grove City, New Wilmington, Wampum, and Zelienople, Pennsylvania (Boroughs). The Company's proposed Rate Level A, which became effective subject to refund on January 24, 1982, would increase revenues by approximately $1.67 million. The proposed Rate Level B, which became effective subject to refund from the date of the initial decision, would produce a further rate increase of approximately $650,000. The rates are open-ended.

The initial decision addresses all issues in Phase I of the proceeding except those relating to the Company's coal purchases from the Quarto Mining Company. Price squeeze issues will be resolved in Phase II. The Boroughs, except for Wampum, have excepted to the initial decision on virtually all issues.

Initially, the Boroughs allege that no increase over the Level A rate can take place prior to a decision on the Quarto coal pricing issue and evaluation of nuclear abandonment costs. These same arguments were also made in the Boroughs' September 6, 1983 objections to a compliance filing made by the Company on August 3, 1983. On January 13, 1984, we issued an order in this docket rejecting the Boroughs' arguments and accepting Penn Power's compliance rates, subject to refund. In accordance with that order, the Level B rates will be effective the date of the initial decision.

Other exceptions by the Boroughs are addressed separately below. To the extent any exceptions are not addressed in this opinion, we affirm and adopt the initial decision on those issues.

Rate of Return

* * *

Capital Structure

* * *

Revenue Credits

* * *

69 Kv Discount

* * *

Cancellation Costs of Nuclear Plants

On January 23, 1980, Penn Power and the other members of the Central Area Power Coordination Group (CAPCO) terminated construction of four jointly owned nuclear units. The Company proposed in this proceeding to recoup its share of the cancellation losses from the ratepayers. The judge ruled that Penn Power could recover its investment over a 10-year period, and directed that it comply with the variable amortization and reporting procedures approved in *Northern States Power Co.*, Opinion No. 134, 17 FERC ¶61,196 (1981). He further determined that the losses may include equity AFUDC and that amortization should begin with the effective date of the rates rather than the actual date of the loss.

The Boroughs have five major exceptions to the judge's decision: (1) The Company failed to prove the prudency of settlement expenditures associated with the loss, as required by *Northern States*, Opinion No. 134, *supra*. (2) The judge erred in allowing amortization to begin on January 24, 1982, rather than recognizing the actual date of the loss, January 20, 1980. (3) Collection of the cancellation charges in wholesale rates is discriminatory and anti-competitive. (4) To the extent cancellation losses are allowed, the common equity portion of AFUDC should be removed. (5) The amortization period should be 30 rather than 10 years since the useful life of the facilities would have been 10 years had they been completed.

For the reasons stated below, we reject the Boroughs' exceptions and affirm the initial decision.

The Commission's policy has been to allow utilities to recover the costs associated with cancelled plant where

investment in the plant was prudent and the cancellation costs are reasonable.[26] No participant in this case challenged the prudence of the Company's decision to cancel the plants, or the amount of loss claimed.

The Boroughs' claim that the Company failed to prove the prudency of its settlement expenditures is misplaced. Settlement expenditures are costs incurred when the utility has to cancel contracts associated with cancelled plants. According to the Boroughs, *Northern States* requires that all vendor settlements be made and determined prudent before *any* cancellation costs can be recovered, and the Company should not be allowed to increase its rates above Level A until the *Northern States* procedures have been fully satisfied. This is not what *Northern States* requires. In that case we tentatively allowed the utility to include estimated abandonment costs in its cost of service, subject to adjustment as the vendor claims were settled and subject to the filing of quarterly reports on the vendor settlements. The procedure set forth in that case, and followed by the judge here, requires that the initial estimated cancellation costs be adjusted to ultimately reflect the actual costs incurred. It did not preclude recovery of any costs prior to a determination of the prudency of the vendor settlements. The judge properly followed the *Northern States* approach.

The second matter raised by the Boroughs is whether amortization of the cancellation losses should begin in January 1980 instead of January 24, 1982. The Bor-

[26] *New England Power Co.*, Opinion No. 49, 8 FERC ¶61,054 (1979), *aff'd sub nom. NEPCO Municipal Rate Committee* v. *F.E.R.C.*, 668 F.2d 1327 (D.C. Cir. 1981), *cert. denied*, 457 U.S. 1117 (1982); *Northern States Power Co.*, Opinion No. 134, 17 FERC ¶61,196 (1981), *aff'd sub nom. South Dakota PUC* v. *F.E.R.C.*, No. 82-1276 (8th Cir. Oct. 19, 1982).

oughs argue that use of the 1982 date is contrary to the Uniform System of Accounts and results in retroactive ratemaking. We find no merit to either argument. First, we are dealing here with proper ratemaking treatment of the cancellation losses, not proper accounting treatment.[27] Second, the Boroughs apparently misunderstand the meaning of retroactive ratemaking. The rule against retroactive ratemaking is that a utility may not set rates to recoup past losses, nor may a regulatory commission prescribe rates on that principle.[28] There has been no attempt to substitute new rates for the rates in effect prior to the January 24, 1982 effective date of the rates in this docket. The Company has sought to include the costs in its rates in the first rate increase filing made after the loss occurred. We affirm the January 24, 1982 date.

The Boroughs also object to the judge's failure to address their contention that inclusion of the cancellation costs in wholesale rates is discriminatory and anti-competitive. They claim they make up only three percent of Penn Power's total sales, yet the Company has been collecting loss charges only from those minority sales. No such costs were charged in the firm power transaction with the parent, Ohio Edison, or in any prior retail cases.

The Boroughs' discrimination arguments tend to ignore the fact that the issue here is whether the cancella-

[27] In any event, by letter dated June 27, 1980, the Commission's Chief Accountant gave Penn Power's parent, Ohio Edison, permission to amortize the losses for both companies over a 10-year period, "beginning with the date rates in your next rate filing which provides for recovery of the property loss become effective."

[28] *Nader* v. *F.C.C.*, 520 F.2d 182, 202 (D.C. Cir. 1975); *City of Piqua* v. *F.E.R.C.*, 610 F.2d 950, 954 (D.C. Cir. 1979); *Public Service Co. of N.H.* v. *F.E.R.C.*, 600 F.2d 944, 957 (D.C. Cir. 1979).

tion losses are just and reasonable costs which should be borne in part by the wholesale customers. They have not shown that the losses are unreasonable or that they are not a legitimate cost to be included in rates. The fact that the Company has not been collecting cancellation costs from the retail customers does not automatically make their inclusion in this proceeding discriminatory. Any substantive evidence to show that the loss charges are discriminatory or anti-competitive should be presented in Phase II.

The Boroughs next argue that the common equity portion of AFUDC should be removed from the costs allowed. The judge rejected their arguments, relying on our decision on the same issue in *Northern States*. We affirm his ruling. In *Northern States*, we determined that the carrying cost on investment is as much a legitimate expense of the project as are the more tangible costs such as parts and materials. We concluded that if the shareholder were required to shoulder part of the AFUDC, the risk of investing in electric utilities would be increased and the cost of capital would increase to the extent necessary to compensate for the additional risk.

On exceptions, the Boroughs contend the instant case is distinguishable from *Northern States* because removal of equity AFUDC in this case would not increase the risk of investment in penn Power. The evidence which purportedly supports their position however, consists of the unsupported opinions of a rate of return witness.[29] They have presented no substantive evidence that would cause us to depart from our findings in *Northern States*. Furthermore, they have failed to address our

[29] Tr. 682-685.

conclusion in that case that it would be improper to single out one component of construction cost (equity AFUDC) for disallowance from amortization, particularly since investors and other readers of a utility's financial statements rely on reported earnings and the assurance that capitalized amounts represent valid assets. We see no reason not to apply the rationale of *Northern States* to this case.

Lastly, the Boroughs seek a 30-year amortization period rather than a 10-year period because 30 years is the expected useful life of the cancelled plants. This "useful life" standard was rejected by us in both *New England Power Co.* and *Northern States, supra.* In both cases we balanced the interests of investors and ratepayers and found the impact on the cost of service as one of the most important factors to be considered. In this case the use of a 10-year period results in an annual allocation of approximately $31,600 to the wholesale customers, or approximately 0.6 percent of the cost of service[30]—a figure comparable to those in the above-mentioned cases. The judge's decision is consistent with precedent and is affirmed.

Unused Investment Tax Credits

* * *

Compliance

Attached as Appendix A is the Commission's required compliance in accordance with the terms of this opinion and order. Rate Level A is found acceptable. Rate Level B is found excessive, thus requiring refunds. However, we note that both Rate Levels A and B are

[30]Exh. 54, p. 2.

subject to further refunds pending the outcome of the Phase II price squeeze proceeding and resolution of the Quarto coal issue.

The Commission orders:

(A) The initial decision issued in this proceeding on June 20, 1983 is affirmed and adopted to the extent not modified herein.

(B) Within 75 days of the issuance of this order, Penn Power shall file revised tariff sheets reflecting the cost of service in Appendix A. However, if an application for rehearing is pending at the end of the 75-day period, such filing shall be made within 30 days from the date the application is disposed of by the Commission.

(C) Within 30 days of the Commission's approval of revised tariff sheets, Penn Power shall refund to its customers, with interest, any amounts collected in excess of those allowed herein.

(D) In accordance with the Commission's January 21, 1982 order setting this case for hearing, any party desiring to pursue the price squeeze issue in this proceeding shall notify the Commission within 75 days following the date of issuance of this opinion. However, if an application for rehearing is pending at the close of the 75-day period, the above-mentioned notification shall be made within 30 days following the date the application for rehearing is disposed of by the Commission.

(E) Within 30 days of the issuance of this opinion, Penn Power shall file with the Commission and the Intervenors a detailed explanation of the $16,031,107 claimed in the proceeding as the final amount related to all vendor settlements. Thereafter, if the above amount is not the final vendor settlements amount, the Company must submit quarterly reports documenting vendor settlements

until all claims have been settled. Any party who believes that the vendor claims have been imprudently settled will have 30 days after the Company's filing to petition the Commission to conduct a further inquiry into the matter. This requirement does not affect the effectiveness of the Level B rates.

By the Commission. Commissioner Sousa dissented in part with a separate statement attached.

(SEAL)

/s/ LOIS D. CASHELL

Lois D. Cashell,
Acting Secretary.

(Issued March 22, 1984)

SOUSA, A. G., COMMISSIONER, *dissenting in part:*

I must dissent from the majority's use of post-record market data to reduce Penn Power's allowed rate of return on common equity from the presiding judge's recommended 17.25% to 16.37%.

* * *

/s/ A. G. SOUSA

A. G. Sousa
Commissioner

APPENDIX K

Jersey Central Power & Light Co. v. FERC

JERSEY CENTRAL POWER & LIGHT COMPANY,
Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent,

Allegheny Electric Cooperative, Inc., et al., Intervenors.

No. 82-2004.

United States Court of Appeals,
District of Columbia Circuit.

Argued Jan. 30, 1986.

Decided Feb. 3, 1987.

As Amended Feb. 3, 1987.

[Summary by West Publishing Co.]

Electric utility petitioned for review of order of the Federal Energy Regulatory Commission modifying utility's rate schedule to exclude from rate base utility's investment in cancelled nuclear power plant and denying utility's petition for rehearing. The Court of Appeals, 730 F.2d 816 affirmed. On petition for rehearing, the Court of Appeals, 768 F.2d 1500, remanded. Petition to rehear the case en banc was granted, 776 F.2d 364. The Court of Appeals, Bork, Circuit Judge, held that utility's allegations raised issue of whether rates ordered by Federal Energy Regulatory Commission were "just and reasonable," entitling utility to evidentiary hearing.

Vacated and remanded.

Starr, Circuit Judge, filed concurring opinion.

Mikva, Circuit Judge, filed dissenting opinion in which Wald, Chief Judge, and Spottswood W. Robinson, III and Harry T. Edwards, Circuit Judges, joined.

BORK, Circuit Judge:

Jersey Central Power and Light Company petitions for review of Federal Energy Regulatory Commission orders modifying the electric utility's proposed rate schedules and requiring the company to file reduced rates. Jersey Central charges that it alleged facts which, if proven, show that the reduced rates are confiscatory and violate its statutory and constitutional rights as defined by the Supreme Court in *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1944). Though it is probable that the facts alleged, if true, would establish an invasion of the company's rights, the Commission refused the company a hearing and reduced its rates summarily.

Throughout the extensive proceedings before both the Commission and this court, the Commission has steadfastly maintained that its summary dismissal of Jersey Central's filing was justified by prior Commission precedent. Faced with the claim that the rate order was inconsistent with the Commission's statutory responsibility to provide just and reasonable rates and with the constitutional prohibition against uncompensated takings, the Commission briefs advance a legal theory which, if adopted by this court, would immunize virtually all rate orders from this type of challenge. The Commission's theory flies in the face of every Supreme Court decision that addresses this subject, and we are bound to reject it.

The intervenors, customers of Jersey Central, advance a quite different rationale for affirming the Commission. They attempt to justify the denial of a hearing with the argument that Jersey Central followed the wrong procedures and therefore lost the opportunity to

have its substantive claims heard. Thus, it is said, it was the company's fault, not the Commission's, that no hearing was held.

That reasoning provides no basis for affirming the Commission. It fails to come to grips with the character of the Commission decision we review. That decision does not rest on adjective law. The Commission in fact reached and peremptorily decided the merits of the utility's claim. The substantive *Hope Natural Gas* issue is, therefore, squarely before us and cannot be avoided by faulting the utility for employing defective tactics. The Commission ruled that Jersey Central's allegations and proffered testimony would not support a higher rate. That substantive ruling means that a hearing would have been pointless. The ruling is inconsistent with *Hope* as well as with other controlling precedent of the Supreme Court and of this court. Reversal and remand for a hearing are thus required.

Though the fact that the Commission reached the merits renders irrelevant the intervenors' procedural rationale, it should be noted that if procedural fault is to be assigned, it should be laid at the Commission's doorstep. In dealing with Jersey Central's rate filings, the Commission applied unclear rules arbitrarily. Moreover, the Commission made plain, contrary to the intervenors' rationale, that no procedure could have been followed that would have guaranteed the hearing sought. The explanation for what has taken place in these convoluted proceedings appears to be less that Jersey Central followed incorrect procedures than that the Commission resists "end result" examination at the agency level, and is deeply antagonistic to court review of ratemaking under the guidelines laid down by *Hope*.

The decision of the Commission is vacated and the case remanded for a hearing at which Jersey Central may finally have its claim addressed.

I.

This case already prompted two opinions from this court, both of which we have since vacated. *See Jersey Central Power & Light Co. v. FERC*, 730 F.2d 816 (D.C. Cir.1984) ("*Jersey Central I*"); *Jersey Central Power & Light Co. v. FERC*, 768 F.2d 1500 (D.C.Cir.1985) ("*Jersey Central II*"). The case has now been reheard *en banc*, and the court has had the benefit of supplemental briefing and oral argument from the parties, the intervenors, and several *amici curiae*.[1]

On March 31, 1982, Jersey Central filed proposed rate schedules with the Commission for wholesale service to six customers. Jersey Central divided its filing into two separate rate increases designated Phase A and Phase B. Phase A has gone into effect, and Phase B is the subject of this litigation.

At issue is the utility's proposed treatment of the $397 million investment lost when it suspended construction of its nuclear generating station at Forked River, New Jersey. The Forked River project was initiated about a decade and a half ago, when federal and state agencies were encouraging utilities to commit substantial amounts of capital to nuclear generating plants

[1]Supplemental briefs were filed by petitioner Jersey Central Power and Light Company, by respondent FERC, by intervenors Allegheny Electric Cooperative, Inc. and the New Jersey Boroughs of Butler, Lavallette, Pemberton, and Seaside Heights, and by four amici: the Pennsylvania Public Utility Commission, the National Association of Regulatory Commissioners ("NARUC"), the Pennsylvania Office of Consumer Advocate, and the National Association of State Utility Consumer Advocates. Oral argument was presented by the parties and intervenors, and by NARUC.

that required lead times of eight to twelve years. The consensus prediction was of substantial and steady increases in the demand for electricity and substantial and continued increases in the price of oil due to the operation of an international oil cartel. Regulated public utilities are under statutory obligations to plan and build the facilities necessary to meet the projected needs of their customers. *See, e.g.*, 16 U.S.C. § 824a(g) (1982); N.J.Stat.Ann. 48.3-3 (West 1969). If firms and households were not to face catastrophic energy prices in the future, it was thought essential that nuclear generating plants be built. All parties agree that Jersey Central's investment at Forked River was prudent when made.

The forecasts of both demand and supply proved wrong. Due to conservation, demand did not rise nearly as much as expected, and, with the collapse of the international cartel, the oil market has experienced a worldwide glut and a dramatic decline in prices. Furthermore, the protracted litigation and political controversy which attended the construction of nuclear power projects resulted in extensive delays and dramatic increases in their ultimate cost. Thus, many investments which were prudent, indeed considered essential, when made, have now by necessity been cancelled. Forked River was one, and in 1980 Jersey Central abandoned it, having concluded that it must devote whatever resources it had available to . . . less capital intensive and more politically acceptable alternatives." Testimony of Dennis Baldassari at 7, Joint Appendix ("J.A.") at 34.

Jersey Central sought to recover the cost of the Forked River investment by amortizing the $397 million over a fifteen-year period, a proposal to which the Commission agreed. Jersey Central also requested, how-

ever, that the unamortized portions be included in the rate base, with a rate of return sufficient to cover the carrying charges on the debt and the preferred stock portions of that unamortized investment. Jersey Central expressly did *not* seek a return on that portion of the unamortized investment allocable to its common equity investors.

In support of its proposal, Jersey Central submitted to the Commission the testimony of Dennis Baldassari, its Vice-President and Treasurer. J.A. at 28-39. Baldassari sought to demonstrate that the financial problems faced by Jersey Central made necessary earnings and revenues at the level contemplated by its filing. Baldassari characterized the utility's financial condition as "delicate." Testimony of Dennis Baldassari at 9, J.A. at 36. Jersey Central was wholly dependent for short-term credit, he explained, on a Revolving Credit Agreement which was subject to termination at any time. The only long-term securities it was able to issue were themselves subject to mandatory repurchase by the utility should the short-term credit then available to it be for any reason terminated. Jersey Central's credit standing was, therefore, predictably low. Standard & Poor's Corporation rated its senior debt securities "BB-", *i.e.*, "regarded, on-balance, as predominantly speculative with respect to capacity to pay interest and repay principal in accordance with the terms of the obligation." Moody's Investors Service had also downgraded Jersey Central's rating, classifying its securities "Ba", *i.e.*, "judged to have speculative elements; their future cannot be considered as well-assured. Often the protection of interest and principal payments may be very moderate, and thereby not well safeguarded during both good and bad times over the future. Uncertainty of position characterizes bonds in this class." *Id.* at 4, J.A. at 31.

Jersey Central's lack of access to long-term capital, and the precariousness of its short-term credit, placed it in serious financial difficulty. Baldassari described the rate increase requested as "the minimum amount necessary to restore the financial integrity of the Company thereby providing the means by which Jersey Central will be able to meet its obligation to provide safe and dependable service in the future." Testimony of Dennis Baldassari at 12, J.A. at 39. The focus of his testimony, therefore, was on the overall rate necessary to preserve his company's access to capital markets and its financial integrity.

The Commission responded by issuing an order summarily excluding the unamortized portion of the investment from the rate base. Order Accepting for Filing and Suspending Revised Rates, Granting Interventions, Granting in Part and Denying in Part Motions for Summary Disposition, and Establishing Procedures, 19 F.E.R.C. (CCH) ¶ 61,208 (May 28, 1982). No discussion or analysis accompanied this portion of the order. The Commission simply noted that "consistent with Commission precedent ... unamortized investment in cancelled plants must be excluded from rate base." *Id.* at 61,403 (footnote omitted). The precedent to which the Commission referred was *New England Power Co.*, 8 F.E.R.C. (CCH) ¶ 61,054 (July 19, 1979), *aff'd sub nom. NEPCO Municipal Rate Comm. v. FERC*, 668 F.2d 1327 (D.C.Cir. 1981), *cert. denied sub nom. New England Power Co. v. FERC*, 457 U.S. 1117, 102 S.Ct. 2928, 73 L.Ed.2d 1329 (1982) ("*NEPCO*"). The utility in *NEPCO* had been permitted to recover the costs of its failed investment by amortizing it over a five-year period, but was denied its request to include the unamortized portion in the rate base.

NEPCO's proposal differed from that later made by Jersey Central in several respects. NEPCO's requested amortization period was only one-third as long as that proposed by Jersey Central; NEPCO proposed a full return on the unamortized portion of the investment, including that allocable to common equity, as opposed to simply a return sufficient to cover the carrying charges on debt and preferred stock portions; and NEPCO never alleged that its financial integrity and its ability to maintain access to capital markets depended upon the rate it was requesting.

Upon receiving the Commission's order, Jersey Central filed an Application for Rehearing, J.A. at 99-135, seeking a full evidentiary hearing in which its proposal, and the factual foundation supporting it, could be examined. Jersey Central argued that NEPCO did not control because the allocation of risk in Jersey Central's proposal was different from, and more favorable to consumers than, the allocation proposed and rejected in *NEPCO*. Jersey Central argued as well that more recent Commission precedent on the treatment of abandoned investments in gas pipeline facilities provided support for its proposal. Finally, Jersey Central advanced a position that became a central issue briefed and argued in this appeal. It is axiomatic that the end result of Commission rate orders must be "just and reasonable" to both consumers and investors, and that, in achieving this balance, the Commission must consider the impact of its rate orders on the financial integrity of the utility. Jersey Central argued that, for these reasons, the Commission may not *summarily* exclude an investment from the rate base when the utility has alleged that its ability to attract capital will be seriously jeopardized as a result. Jersey Central contended that it was entitled to a

hearing at which it would have the opportunity to prove its allegations and demonstrate that the end result of the Commission's orders violated the applicable statutory and constitutional standards, a hearing that would create a record through which the Commission's effort to balance the relevant consumer and investor interests would be subject to judicial review.

Alternatively, since Jersey Central's concern was with the end result of the rate order, it requested an evidentiary hearing at which it could justify a rate of return higher than that included in its original filing to compensate for the rate base limitation that the agency claimed was necessitated by Commission precedent. The rate allowed a utility is the sum of (1) its cost of service, and (2) its rate base multiplied by its rate of return. Since the Commission's order had excluded Forked River from the rate base, Jersey Central suggested that the necessary rate could be achieved through raising the rate of return.

The Commission again refused to grant Jersey Central a hearing. The Commission explained, somewhat cryptically:

> We recognize that, in accord with *Hope Natural Gas Co., supra*, it is the "end result" which must be just and reasonable. Nonetheless, the reasonableness of that end result cannot be evaluated without regard to the individual components which comprise a rate. . . .
>
> . . . JCP & L's argument that our decision to exclude cancelled project costs from rate base is not mandated by Commission precedent is . . . without merit. Furthermore, the argument that a hearing is required in order to implement this policy deter-

> mination, is erroneous. Since Opinion No. 49, the Commission has consistently resolved this issue through summary disposition.

Order Granting in Part and Denying in Part Application for Rehearing, 20 F.E.R.C. (CCH) ¶ 61,083, at 61,181-82 (July 23, 1982) (footnote omitted). The Commission then denied the request for a hearing on the alternative proposal of a higher rate of return, on the grounds that modifying the filing at that stage would unfairly present the Commission and the intervenors with a "moving target," and, further, that Jersey Central's "case-in-chief contain[ed] no testimony or exhibits which would support a higher return." *Id.* at 61,182. When the Commission denied Jersey Central's Application for Rehearing and Reconsideration as well, this appeal was filed.

A unanimous panel of this court affirmed the Commission. The utility claimed that the Commission's orders were not the product of reasoned decisionmaking because they were inconsistent with the gas pipeline cases and because application of the *NEPCO* precedent to the facts of this case was irrational. The utility also claimed that it was entitled to an evidentiary hearing in which it could justify its alternative request for a higher rate of return. All these claims were rejected. We then turned to Jersey Central's contention that *Hope Natural Gas* required that there be a hearing to ensure that the "end result" of the rate order was "just and reasonable." The path we took in resolving this issue was later challenged by *both* parties:

> Jersey Central argues that, as a result of the Commission's orders, its rate of return overall will be too low to be characterized as "just and reasonable." In denying rehearing, however, the Commission responded that "the reasonableness of that end result cannot be evaluated without regard to the individual components which comprise a rate." Commission Order at 61,181. This is a rather terse explanation and we wish that in the future the Commission would share its undoubted expertise with us a bit more generously. We understand the Commission to be saying, however, that the end result is to be judged by the rate of return allowed on items for which a rate of return is allowable, the Forked River expenditure is not such an item, and the rates are just and reasonable as to those cost items that are properly in the rate base. The dispute thus boils down to the question of whether the end result test is to be applied to a utility overall or only to those assets which valid Commission rules permit to be included in the rate base.

Jersey Central I, 730 F.2d at 823. Having thus defined the dispute, we accepted what we thought to be the Commission's position and concluded that the end result applied only "to those assets which valid Commission rules permit to be included in the rate base."

In its petition for rehearing before this court, Jersey Central stated that we had mischaracterized the "end result" test by focusing not on the result of the rate order but on the determination of the rate base, which is only one component of that order. We asked the Commission for a response, and it provided one we found incomprehensible:

> In the Commission's view the Court characterized the "end result" test more narrowly than the Commission would have; and, accordingly, it believes it would be appropriate for the Court to amend this aspect of its opinion. Nevertheless, the Commission believes the Court properly affirmed the Commission's orders in this case, since it is well-settled that

> the end-result test only has application to items which are legitimately included in the rate base as "used and useful."

Response of Respondent FERC to Petition for Rehearing at 2. Since this response seemed both to reject and accept our reasoning, the Commission had still not offered us any guidance as to how it construed *Hope*'s "end result" test. Dissatisfied, the court entered a further order which read, in pertinent part:

> [W]e direct the Commission to elaborate on its cryptic comment that, "[i]n the Commission's view the Court characterized the 'end result' test more narrowly than the Commission would have; and, accordingly, it believes it would be appropriate for the Court to amend this aspect of its opinion." Response at 2. This statement is unhelpful. The Commission should explain how and why it believes that the opinion should be amended. We therefore order that the Commission provide further explanation of its position in the brief we have today directed it to file. Throughout these proceedings the court has found the Commission's submissions singularly terse and uninformative.

Order of July 16, 1984. The Commission filed a second response in which it now agreed with Jersey Central that the end result test does not only apply to those assets which valid Commission rules permit to be included in the rate base. Brief for Respondent FERC in Response to the Court's Order of July 16, 1984, at 4. The second response described the "end result" test as "simply an expression for broadly gauging whether, based on all the facts before it, the Commission's orders in a particular case produce a reasonable result." *Id.* at 5. The Commission nevertheless suggested that the end result test was not a standard under which a court was

authorized to set aside an unjust end result, but rather "was designed to accord the Commission broad discretion over all aspects of rate-making methodology." *Id.* at 6.

This response meant that the "end result" test applied to the overall situation produced by the Commission's action but that the Commission not only refused to hold a hearing on that subject but also believed its refusal to be virtually immune from judicial review. Finding no support for the arresting proposition that the Commission was immune from challenges in court over rate orders alleged to violate statutory and constitutional guarantees explicated by the Supreme Court, the panel—now divided—vacated its prior decision. Jersey Central had alleged that "for four years [it] had been unable to pay any dividends on its common stock"; that in part as a consequence of the Commission's orders it had been "repeatedly on the edge of being forced into bankruptcy"; and that since 1979 it

> has had no access to the long-term capital markets and has been wholly dependent upon a short-term revolving credit agreement which was subject to termination at a moment's notice. [The company] has been allowed sufficient cash flow to enable [it] to avoid bankruptcy (but not to provide earnings [sufficient] to enable [it] to attract capital or maintain credit).

Petition for Rehearing and Suggestion for Hearing En Banc at 14. Since the Commission had never held a hearing, there was no way of knowing whether these allegations were true, but we noted that if they were, it "would suggest that FERC's actions were illegal under the end result test of *Hope Natural Gas*," *Jersey Central II*, 768 F.2d at 1502, because the Commission might well

have failed to achieve "a reasonable balancing of investor and consumer interests in keeping with the requirement that rates be 'reasonable, just, and non-discriminatory.'" *Id.* at 1503. We therefore remanded the case to the Commission for a hearing at which Jersey Central would have the opportunity to present its evidence on the inadequacy of the rates allowed it. *Jersey Central II* was vacated when a majority of the court voted to rehear this case *en banc*.

II.

A.

The parties offer radically differing views of the Commission's obligations under *Hope Natural Gas*, a decision in which the Supreme Court set forth the applicable standard of judicial review when rates ordered by an agency are challenged in court as failing to meet the statutory requirement that they be "just and reasonable." The *Hope Court* was construing the Natural Gas Act of 1938, §§ 4(a), 5(a), 52 Stat. 821, 822, 823–24 (codified as amended at 15 U.S.C. §§ 717c(a), 717d(a) (1982)). The Federal Power Act, 16 U.S.C. § 824d(a) (1982), the source of the claim in this case, also requires that rates be "just and reasonable," and courts rely interchangeably on cases construing each of these Acts when interpreting the other. *Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571, 577 n. 7, 101 S.Ct. 2925, 2930 n. 7, 69 L.Ed.2d 856 (1981). Since the Court had previously indicated that "the Congressional standard prescribed by this statute coincides with that of the Constitution," *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586, 62 S.Ct. 736, 743, 86 L.Ed. 1037 (1942), the *Hope* test defines the point at which a rate becomes unconstitutionally confiscatory as well.

In these proceedings the Commission itself has never stated what the "end result" test of *Hope Natural Gas* requires of it or of a reviewing court. In *Jersey Central I* and *II*, the Commission's appellate counsel offered us only the vague statements of the Commission's duties already quoted. As to the reviewing court's power under *Hope*, counsel told the panel in those proceedings essentially that the reviewing court had little, if any, function to perform. However, at oral argument before the court *en banc*, counsel finally advanced the novel proposition that the "end result" test empowers a court to set aside a rate order on the utility's petition only if the order would put the utility into bankruptcy. In order to show how dramatically at odds with the law that position is, we review the history of the doctrine at issue.

Hope Natural Gas reaffirmed a doctrinal shift, begun in *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 62 S.Ct. 736, 86 L.Ed. 1037 (1942), away from the more exacting and detailed standard of judicial review exemplified by *Smyth v. Ames*, 169 U.S. 466, 185 S.Ct. 418, 42 L.Ed. 819 (1898). Under *Smyth v. Ames*, courts had meticulously scrutinized rate orders to ensure that investors received the "fair value" of the property dedicated to public use. The "fair value" standard required courts to estimate the current market value of the property, and rates that provided anything less were deemed confiscatory. The governing theory required that consumers pay the market value of the property they were using because the property was regarded as having been taken. Recovery was therefore required only on property "used and useful" to the public, for property that was not being used could not be considered to have been taken. The Supreme Court cases of the 1940's eliminated the requirement that the market value of the property be

recovered, and regulated industries now collect rates calculated to generate a reasonable return on the *original cost* of the investment. The companies are still generally permitted to include in the rate base only property considered used and useful, but with the demise of "fair value," "used and useful" ceased to have any constitutional significance, and the Commission has at times departed from this standard. It is now simply one of several permissible tools of ratemaking, one that need not be, and is not, employed in every instance. *See Washington Gas Light Co. v. Baker*, 188 F.2d 11 (D.C.Cir.1950), *cert. denied*, 340 U.S. 952, 71 S.Ct. 571, 95 L.Ed. 686 (1951).

In setting aside the rigorous judicial scrutiny that had previously characterized review of rate orders, the Supreme Court substituted a far more deferential standard of review:

> Once a fair hearing has been given, proper findings made and other statutory requirements satisfied, the courts cannot intervene in the absence of a clear showing that the limits of due process have been overstepped. If the Commission's order, as applied to the facts before it and reviewed in its entirety, produces no arbitrary result, our inquiry is at an end.

FPC v. Natural Gas Pipeline Co., 315 U.S. at 586, 62 S. Ct. at 743. This new emphasis—on whether the order "viewed in its entirety" was the product of "proper findings" and was not "arbitrary"—evolved two years later into the "end result" test of *Hope Natural Gas*.

The *Hope* Court made clear that when a rate was claimed to be beyond "just and reasonable" boundaries, the focus of analysis was to be the end result of that order:

> [I]t is the result reached not the method employed which is controlling. . . . It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. . . . And he who would upset the rate order under the Act carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences.

320 U.S. at 602, 64 S.Ct. at 287 (citations omitted). Judging a rate order's consequences, the Court held, necessarily required a "balancing of the investor and the consumer interests." *Id* at 603, 645 S.Ct. at 288. The legitimate investor interest, which is the interest Jersey Central claims received inadequate attention in the proceedings before the Commission, was defined in *Hope* to include:

> the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock.

Id. The return, therefore, "should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *Id*.

Thus, in reviewing the rate order challenged in *Hope*, the Court considered the detailed findings made by the Commission concerning the financial condition of Hope Natural Gas Company. 320 U.S. at 603–05, 64 S.Ct. 288–89. After examining all of the relevant figures, the Commission had concluded that "[t]he company's efficient management, established markets, financial record, affiliations, and its prospective business place it

in a strong position to attract capital upon favorable terms when it is required." 44 P.U.R. (N.S.) 1, 33 (1942), *quoted in Hope*, 320 U.S. at 605, 64 S.Ct. at 289. After summarizing the Commission's findings and conclusions concerning the company's financial health, the Court held:

> In view of these various considerations we cannot say that an annual return of $2,191,314 is not "just and reasonable" within the meaning of the Act. Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they might produce only a meager return on the so-called "fair value" rate base.

320 U.S. at 605, 63 S.Ct. at 289.

In *Hope Natural Gas*, the rate was challenged as too low to account adequately for the legitimate interests of the investor. In *Washington Gas Light Co. v. Baker*, 188 F.2d 11 (D.C.Cir.1950), *cert. denied*, 340 U.S. 952, 71 S.Ct. 571, 95 L.Ed. 686 (1951), this court heard a challenge by a consumer who claimed that a rate increase approved by the Public Utilities Commission of the District of Columbia was too high to account adequately for the legitimate interests of the purchaser. The court applied the same analytical framework. Because the local public utilities commission was governed by the same standard as the Federal Power Commission, 188 F.2d at 14, Judge Bazelon's opinion examined the rate order under the rule set forth in *Hope Natural Gas*:

> So long as the public interest—i.e., that of investors and consumers—is safeguarded, it seems that the Commission may formulate its own standards. But

> there are limits inherent in the statutory mandate that rates be "reasonable, just, and nondiscriminatory." Among those limits are the minimal requirements for protection of investors outlined in the Hope case. And from the earliest cases, the end of public utility regulation has been recognized to be protection of consumers from exorbitant rates. Thus, there is a zone of reasonableness within which rates may properly fall. It is bounded at one end by the investor interest against confiscation and at the other by the consumer interest against exorbitant rates.

Id. at 15 (footnotes omitted). The court then set aside the rate order and remanded for further proceedings, on the ground that the Commission had not made sufficiently detailed findings of fact concerning the financial health of the company involved to support the reasonableness of its rate increase. "Despite the broad limits allowed the Commission, it remains imperative that its findings, under whatever formula adopted, be based upon substantial evidence in the record." *Id.* (footnote omitted). In that case, this court also indicated that the Commission was not obligated to exclude from the rate base all property not presently "used and useful," but was free to include prudent but cancelled investments. *Id.* at 19.

The Supreme Court has repeatedly reaffirmed the "end result" standard of *Hope Natural Gas*. *See, e.g., FPC v. Memphis Light, Gas & Water Division*, 411 U.S. 458, 474, 93 S.Ct. 1723, 1732, 36 L.Ed.2d 426 (1973) ("under *Hope Natural Gas* rates are 'just and reasonable' only if consumer interests are protected and if the financial health of the pipeline in our economic system remains strong"); *Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581, 605, 65 S.Ct. 829, 840, 89 L.Ed. 1206 (1945) ("end

result" test "is not a standard so vague and devoid of meaning as to render judicial review a perfunctory process. It is a standard of finance resting on stubborn facts."). In *Permian Basin Area Rate Cases*, 390 U.S. 747, 88 S.Ct. 1344, 20 L.Ed.2d 312 (1968), the Court reviewed Commission orders setting area-wide rates for gas producers. Writing for the majority, Justice Harlan stated that a court reviewing rate orders must assure itself *both* that "each of the order's essential elements is supported by substantial evidence" *and* that "the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable." *Id.* at 792, 88 S.Ct. at 1373. In examining the end result of the rate order, he made clear, a court cannot affirm simply because each of the component decisions of that order, taken in isolation, was permissible; it must be the case "that they do not *together* produce arbitrary or unreasonable *consequences*." *Id.* at 800, 88 S.Ct. at 1377 (emphasis added). The Court in *Permian Basin* emphasized the necessity for Commission findings, the existence of which is a necessary predicate to judicial deference:

> The Court's responsibility is not to supplant the Commission's balance of these interests with one more nearly to its liking, but instead to assure itself that the Commission has given reasoned consideration to each of the pertinent factors. Judicial review of the Commission's orders will therefore function accurately and efficaciously only if the Commission indicates fully and carefully the methods by which, and the purposes for which, it has chosen to act, as well as its assessment of the consequences of its orders for the character and future development of the industry.

Id. at 792, 88 S.Ct. at 1373. And the Court once again reviewed the findings below and affirmed upon concluding that "the record before the Commission contained evidence sufficient to establish that these rates, as adjusted, will maintain the industry's credit and continue to attract capital." *Id.* at 812, 88 S.Ct. at 1383.

The teaching of these cases is straightforward. In reviewing a rate order courts must determine whether or not the end result of that order constitutes a reasonable balancing, based on factual findings, of the investor interest in maintaining financial integrity and access to capital markets and the consumer interest in being charged non-exploitative rates. Moreover, an order cannot be justified simply by a showing that each of the choices underlying it was reasonable; those choices must still add up to a reasonable result. Because the language of these cases is so plain, and the standard applied in each is the same, the preceding lengthy account may have appeared unduly repetitious. We have set out guiding precedent comprehensively, however, because the legal position taken by the Commission is at odds with every one of the requirements specified by these decisions.

In the face of a serious *Hope* challenge, the Commission made no findings, performed no balancing, offered no reasoned consideration of Jersey Central's allegations and proffered testimony, misstated the law by saying that the reasonableness of the end result cannot be evaluated without regard to the individual components that go into a rate, and, most recently, claimed that our reviewing function was ended if the rate order did not cast Jersey Central into bankruptcy.

This performance alone would justify reversal and a remand for a *Hope* hearing. But there was more: the Commission reached the merits and ruled that Jersey Central's allegations and testimony did not even raise a *Hope* issue. That was plain legal error.

B.

The allegations made by Jersey Central and the testimony it offered track the standards of *Hope* and *Permian Basin* exactly. The *Hope* Court stated that the return ought to be "sufficient to ensure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital," and that "it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock." 320 U.S. at 603, 64 S.Ct. at 288. *Permian Basin* reaffirmed that the reviewing court "must determine" whether the Commission's rate order may reasonably be expected to "maintain financial integrity" and "attract necessary capital." 390 U.S. at 792, 88 S.Ct. at 1373. Jersey Central alleged that it had paid no dividends on its common stock for four years and faced a further prolonged inability to pay such dividends. Baldassari's testimony explained that the company was unable to sell senior securities; that its only source of external capital was the Revolving Credit Agreement, which was subject to termination and which placed the outstanding bank loans the company was allowed to maintain below the level necessary for the upcoming year; that the need to pay interest on the company's debt and dividends on its preferred stock meant that common equity investors not only were earning a zero return, but were also forced to pay these interest costs

and dividends and that "continued confiscation of earnings from the common equity holder . . . will prolong the Company's inability to restore itself to a recognized level of credit worthiness"; that its "inability to realize fully its operating and capital costs so as to provide a fair rate of return on its invested capital has pushed its financial capability to the limits"; that "[a]dequate and prompt relief is necessary in order to maintain the past high quality of service"; and that the rate increase requested was "the minimum necessary to restore the financial integrity of the Company," Testimony of Dennis Baldassari at 5–6, 7, 10, 12, J.A. at 32–33, 34, 37, 39.

Inexplicably, the Commission ruled that Jersey Central's showing did not require a hearing because there were "no testimony or exhibits which would support a higher return." That ruling is flatly at odds with *Hope* and *Permian Basin*. Moreover, the Commission, having held no hearing, made no findings in support of its ruling and gave not a single reason for it. If the Commission and this court are bound by Supreme Court precedent, and we are, the Commission's case cannot stand.

C.

The Commission's apparent understanding of *Hope Natural Gas*, adopted by the dissent in *Jersey Central II*, is that the "end result" test acts only as a limitation of, and not at all as an authorization for, judicial review of rate orders. While the Commission "*may* also look to the criteria of *Hope* in determining whether its rate order is just and reasonable and *may* make pragmatic adjustments based on the perceived need to balance investor and consumer interests," Brief on Rehearing En Banc for Respondent FERC at 16 (emphasis added), it apparently considers a decision whether or not to do so

completely within its discretion. While the Commission's briefs have never explicitly claimed that courts are without authority to set aside rate orders deemed unjust and unreasonable in their consequences, or based upon insufficient findings, at no point in response to our numerous requests for briefing has the Commission indicated any role it believes proper for courts to play in reviewing the reasonableness of rate orders, save that of passively affirming them. Only at oral argument before the *en banc* court did Commission counsel concede that a court might set aside a rate order under *Hope* if the order would drive the company into bankruptcy, but that was the limit of the judicial power acknowledged.

The rationale for the Commission's position is difficult to discern, for, as noted in Section IIA, *supra*, that position can derive no support from the case law it purports to embody. The Commission, it appears, rests its theory in part on the fact that *Hope Natural Gas* represented a shift from strict to deferential judicial review, and, in the historical context in which it was decided, constituted a limitation on judicial review when compared to the standard it was replacing. But judicial review, while limited, was not eliminated, and the "end result" standard—like any standard of judicial review—confines judicial power not by eliminating review but by defining its reach. The delineation marked by the "end result" test thus simultaneously authorizes and constrains the courts that apply it. This is elementary jurisprudence.

The Commission also apparently locates support in language set forth in *Hope:* "If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end." *Hope*,

320 U.S. at 602, 64 S.Ct. at 288. *See also Jersey Central II*, 768 F.2d at 1511 (Mikva, J., dissenting). The Commission's litigating stance appears to interpret the Court's statement as if it were but one half of a larger proposition the Court meant to enunciate: judicial review is at an end if *either* the end result is just and reasonable *or* if it is not. Had he meant any such thing, Justice Douglas would simply have said that there is no more judicial review. Instead, he said that "he who would upset the rate order under the Act carries the heavy burden of making a convincing showing that it is invalid *because* it is unjust and unreasonable in its consequences." *Hope*, 320 U.S. at 602, 64 S.Ct. at 288 (emphasis added). He then went on to review the financial situation of the company, an exercise that would have been wholly superfluous if he had just announced the demise of judicial review. If the contrary view apparently embraced by the Commission were adopted, the end result standard would become "so vague and devoid of meaning as to render judicial review a perfunctory process." *Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581, 605, 65 S.Ct. 829, 840, 89 L.Ed. 1206 (1945).

The Commission maintains that because excluding the unamortized portion of a cancelled plant investment from the rate base had previously been upheld as *permissible*, any rate order that rests on such a decision is unimpeachable. But that would turn our focus from the end result to the methodology, and evade the question whether the component decisions together produce just and reasonable consequences. We would be back with the assertion made in *Jersey Central I* that "the end result test is to be applied . . . only to those assets which valid Commission rules permit to be included in the rate base." 730 F.2d at 823. That statement was one

which neither party endorsed. It was incorrect. The fact that a particular ratemaking standard is generally permissible does not *per se* legitimate the end result of the rate orders it produces. Justice Harlan said just that in *Permian Basin*.

The position presented on behalf of the Commission, as we earlier observed, shifted to a minor extent during the course of these proceedings. At oral argument before the *en banc* court, counsel for the Commission indicated that the "end result" test *did* allow a court to set aside a rate order when the company would otherwise go bankrupt and the Commission had refused to take that into account. The source of this constricted standard is elusive, not to say invisible. *Hope Natural Gas* talks not of an interest in avoiding bankruptcy, but an interest in maintaining access to capital markets, the ability to pay dividends, and general financial integrity. While companies about to go bankrupt would certainly see such interests threatened, companies less imminently imperiled will sometimes be able to make that claim as well. Jersey Central alleges that it is such a company. The contention that no company that is not clearly headed for bankruptcy has a judicially enforceable right to have its financial status considered when its rates are determined must be rejected.

The dissent agrees with the Commission that *Hope* stands generally for a restriction on judicial review of a rate order, but erects its own constricted standard to determine when a company may obtain consideration of its financial status in review of a rate order. According to the dissent, Jersey Central could get a *Hope* hearing only by first making a sufficient showing on three critical points: that a "critical nexus" exists between the

rate order and the utility's financial plight; that the proposed rate filing would not lead to the exploitation of consumers; *and* that the overall return allowed on this project is not reasonable, and thus puts the company in need of protection at this phase of the ratemaking process. Dissent at 1205–09. It is remarkable that the dissent would affirm the Commission on a legal theory that neither the Commission nor its counsel ever advanced. The Commission offered no legal theory and counsel offered the unique bankruptcy-only theory. It is impossible to affirm on the basis of the Commission's silence or counsel's rationale. It should be equally impossible to suggest affirmance on the basis of a legal theory never surfaced until today. Indeed, the only correspondence between the three different postions taken by the Commission, its counsel, and the dissent, aside from their common hostility to *Hope*, is that none of them has any basis in any decision of any previous court. The dissent's new three-part barrier flatly ignores the factors that, according to the Supreme Court's controlling opinion in *Hope*, would necessitate an "end result" hearing into whether any revision of a rate order is necessary in light of a company's financial plight. Since Jersey Central submitted figures and testimony to support its claim that the rate order caused its financial distress, that its proposed rates would not exploit consumers, and that the overall rate of return allowed is not just and reasonable, one can only suppose that the dissent demands proof beyond doubt of its three criteria before the hearing is even held. That, most certainly, is not what *Hope* requires. The dissent thus joins the Commission in rejecting the Supreme Court's law.

In addition to prohibiting rates so low as to be confiscatory, the holding of *Hope Natural Gas* makes clear

that exploitative rates are illegal as well. If the inclusion of property not currently used and useful in the rate base automatically constituted exploitation of consumers, as one of the *amici* maintains, then the Commission would be justified in excluding such property summarily even in cases where the utility pleads acute financial distress. A regulated utility has no constitutional right to a profit, *see FPC v. Natural Gas Pipeline Co.*, 815 U.S. at 590, 62 S.Ct. at 745, and a company that is unable to survive without charging exploitative rates has no entitlement to such rates. *Market Street Ry. v. Railroad Comm'n of Cal.*, 324 U.S. 548, 65 S.Ct. 770, 89 L.Ed. 1171 (1945). But we have already held that including prudent investments in the rate base is not in and of itself exploitative, *Washington Gas Light Co. v. Baker*, and no party has denied that the Forked River investment was prudent. *Hope*, 320 U.S. at 603, 64 S.Ct. at 288.[2]

The central point, however, is this: it is impossible for us to say at this juncture whether including the unamortized portion of Forked River in the rate base would exploit consumers *in this case*, or whether its exclusion, *on the facts of this case*, constitutes confiscation, for no findings of fact have been made concerning the consequences of the rate order.[3] Nor, for the same reason, can we make a judgment about the higher rate of

[2]We have been reminded by the Commission and several of the *amici* that utilities ought not be immunized from the free play of market forces. Their application of this principle is peculiarly selective. Had the international oil cartel *not* collapsed, and had Forked River provided unusually inexpensive energy in a time of scarcity and high demand, Jersey Central would have received no windfall, but simply the standard return on its original investment. It seems odd, therefore, that it must bear so disproportionate a share of the loss when the prudent investment it made pursuant to its statutory obligations fails.

[3]We emphasize that we do not hold that a taking occurs every time a prudent investment is made but not included in the rate base. We thus explicitly reject the dissent's contention that under our holding "the investor

(footnote continued on next page)

return the utility sought as an alternative to inclusion in the rate base of its unamortized investment. Jersey Central has presented allegations which, if true, suggest that the rate order almost certainly does not meet the requirements of *Hope Natural Gas*, for the company has been shut off from long-term capital, is wholly dependent for short-term capital on a revolving credit arrangement that can be cancelled at any time, and has been unable to pay dividends for four years. In addition, Jersey Central points out that the rates proposed in its filing would remain lower than those of neighboring utilities, *see, e.g.*, Petition for Rehearing and Suggestion for Hearing En Banc at 8, which at least suggests, though it does not demonstrate, that the proposed rates would not exploit consumers. The Commission treated those allegations as irrelevant and hence has presented us with no basis on which to affirm its rate order. The necessary findings are simply not there for us to review. When the Commission conducts the requisite balancing of consumer and investor interests, based upon factual findings, that balancing will be judicially reviewable and will be affirmed if supported by substantial evidence. That is the point at which deference to agency expertise will be appropriate and necessary. But where, as here, the Commission has reached its determination by flatly refusing to consider a factor to which it is undeniably required to give some weight, its decision cannot stand. *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 416, 91 S.Ct. 814, 823, 28 L.Ed.2d

is guaranteed a return on his investment, if prudent when made." Dissent at 1212. Whether or not such an approach might be desired as a matter of policy, our holding simply follows *Hope*. If a utility is in that state, the Commission must inquire whether a reasonable return—on investment, not on facilities—has been afforded to investors, taking into account whether any higher return would amount to exploitation of consumers. Under those circumstances, it may be permissible or even proper to grant the utility a greater return on its prudent investments than it otherwise would have received.

136 (1971).[4] The case should therefore be remanded to the Commission for a hearing at which the Commission can determine whether the rate order it issued constituted a reasonable balancing of the interests the Supreme Court has designated as relevant to the setting of a just and reasonable rate.[5]

III.

The intervenors, Allegheny Electric Cooperative and four boroughs of New Jersey, all purchasers of energy from Jersey Central, present an argument different

[4]This case thus raises completely different issues from those decided in *Pennsylvania Elec. Co. v. Pennsylvania Pub. Util. Comm'n*, 509 Pa. 324, 502 A.2d 130 (1985). The appeal from that decision was dismissed for want of a substantial federal question. In *Pennsylvania Elec. Co.*, as in this case, a public utility commission ordered the costs associated with an abandoned nuclear plant excluded from the participating companies' rate bases. However, when those companies filed complaints alleging that the rates were not just and reasonable and tariffs seeking rate increases, they were given a hearing and a rate increase—although not as large a one as they had requested.

They therefore appealed. *Pennsylvania Elec. Co.*, 502 A.2d at 132, 134. Jersey Central has been afforded no hearing, unlike Metropolitan Edison, and the Commission in this case has ignored, rather than balanced, the factors that the Pennsylvania court has said ought to be weighed.

[5]The dissent argues that it is inappropriate to use calculations involving the rate base to address the financial problems suffered by utilities. Dissent at 1203-1204. But we do not hold that the Commission *must* adjust the rate base or that it *must* make any specific form of adjustment, or even any adjustment at all. It is only required to hold the "end result" hearing discussed in *Hope*. After the hearing it *may* be determined that adjustments need to be made to the Jersey Central rate order, but we express no view as to the precise manner in which any such adjustments would have to be made, so long as whatever is done is satisfactory. On a different front, the dissent speculates that the Commission's actions may only affect a minor portion of Jersey Central's business, and that it would be wrong for the Commission to grant full relief for all of the utility's financial problems. Dissent at 1206–07. We of course do not require the Commission to take such broad steps; we only require it to hold the hearing mandated in *Hope* and to consider whether *any* adjustments, even perhaps partial adjustments, should be made in light of the factors discussed in *Hope*.

from that advanced by the Commission. Intervenors urge that we affirm the Commission on the sole ground that Jersey Central made the wrong filing. The dissent agrees.

The argument made by the dissent and the intervenors is purely procedural. They assert that the Commission has a "rule" against including the unamortized portion of an abandoned investment in the rate base; that Jersey Central "ignored" this "rule" when it made its filing; that Jersey Central could have "received what it wanted"—*i.e.*, a hearing before the Commission on its *Hope* claim—had it filed instead a request for a higher rate of return or a shorter amortization period; that those filings, in contrast to the filing actually made, would have been consistent with Commission rules; and that Jersey Central has therefore forfeited whatever claim it might have had to a higher rate, and, accordingly, that the summary dismissal ought to be affirmed. Supplementary Brief Submitted by Intervenors at 9–11, 14–15.

This procedural rationale, it is worth noting, was never advanced by the Commission: not in the orders under review, not at the original hearing before a panel of this court, not in its first response to the petition for rehearing, not in its second response, and not in its submission to the *en banc* court. Moreover, the point that the intervenors and the dissent seek to make the pivot of this case was not perceived by the panel in its unanimous first decision or by either the majority or the dissent in the panel's second decision. The point was not the reason we granted rehearing *en banc*. That was done entirely to rehear the *Hope* "end result" issue. The procedural argument was raised only at the *en banc* stage.

But the oddest aspect of this entire history is that the Commission has never said what the intervenors and the dissent say: that Jersey Central could have had a hearing on the *Hope* "end result" test if only it had followed some other procedure. The fact that the Commission never relied on this argument might be reason enough to reject it. And, in any event, because the Commission did rule that Jersey Central's proffer was inadequate, and thus committed legal error under *Hope*, it is not strictly necessary that we discuss the procedural point. The merits were reached and the claims were wrongly dispatched without any provision of the "end result" hearing required by *Hope*. Nonetheless, even though it makes no difference to the ultimate resolution of this case, we think it well to show this procedural contention is wrong. The intervenors' characterization of the utility's filing and its interpretation of the available Commission procedures do not withstand analysis.

A.

The intervenors and the dissent assert that in requesting rate-base treatment for the unamortized portion of the costs of the cancelled plant, Jersey Central violated the "rule" established by the Commission in *NEPCO*. There was, however, no suggestion in that case that the Commission was establishing any ironclad rule. The subject of that proceeding was the proper treatment of a cancelled generating unit at NEPCO's Salem Harbor facility. The Commission was faced with a number of issues, such as the length of the amortization period and the percentage of costs the utility would be permitted to amortize. It was also faced with the question of whether the unamortized portion of those costs should be included in the rate base. The Commission re-

solved that question by simply quoting from, and indicating its agreement with, the findings of the Administrative Law Judge, who had concluded that "[t]here is no precedent, or *reasonable justification in the record of this proceeding*, to require ratepayers to pay a return on an expenditure that has not resulted in productive plant that is used or useful in the public service." *NEPCO*, 8 F.E.R.C. (CCH) at 61,175 (emphasis added). The Commission had decided that application of the used and useful principle in that case, on the basis of the facts presented, would yield a reasonable balancing of the competing interests. It was not, as the intervenors suggest and the dissent states, establishing a rigid rule.

When NEPCO challenged the Commission's decision before this court, it was unsuccessful. *NEPCO Municipal Rate Comm. v. FERC*, 668 F.2d 1327 (D.C.Cir. 1981), *cert. denied sub nom. New England Power Co. v. FERC*, 457 U.S. 1117, 102 S.Ct. 2928, 73 L.Ed.2d 1329 (1982). NEPCO argued that *any* application of the used and useful principle that led to the denial of a return on prudently-invested capital was unconstitutionally confiscatory. We rejected that argument, and accepted that advanced by the Commission in its brief: "*In The Circumstances Of This Case*, The Commission Correctly Allowed The Utility To Recover Costs (But No Profit) For Cancelled Facilities," Brief for Respondent FERC at 18 (Argument Subheading I.B. 2) (emphasis added). We did not hold that the balance struck in *NEPCO* would be upheld in any future proceeding to which it was applied, regardless of the facts involved. Instead, we simply declined to hold, as urged by the utility, that failure to allow a return on prudently-invested capital was *per se* unconstitutional, and we affirmed the Commission's decision to employ the "used and useful" principle,

finding that NEPCO had "set forth no compelling reason for departing from that approach *in this case.*" *NEPCO*, 668 F.2d at 1335 (emphasis added).

In at least four subsequent proceedings, the Commission relied on *NEPCO* in summarily excluding the unamortized costs of cancelled plants from the rate base. While the intervenors overstate the matter by referring to the *NEPCO* precedent as a rule, it is fair to say that application of the precedent to routine cases like those was becoming a practice. Jersey Central's filing, however, was anything but routine. It presented allegations suggesting material differences between its situation and those presented in the *NEPCO* line of cases. First, the amount of the loss was on an entirely different scale. The Commission had never applied *NEPCO* to a loss at the order of magnitude of nearly $400 million. (*Ohio Edison Co.*, 18 F.E.R.C. (CCH) ¶ 61,010 (Jan. 8, 1982), for example, involved a loss of $773,146.) Second, in none of the previous cases had the petitioner suggested that it was facing financial distress of the sort threatening Jersey Central. Third, Jersey Central's filing proposed an amortization period three times longer than that established in *NEPCO*. A longer amortization period strikes a balance more favorable to ratepayers, and Jersey Central was apparently willing to accept lower revenues in exchange for the higher recorded earnings which would have accompanied rate-base treatment of the cancelled plant, since it needed to record earnings in order to regain its access to the capital markets.

These factual differences distinguishing *NEPCO* from the case before us are substantial. In *Michigan Wisconsin Pipe Line Co. v. FPC*, 520 F.2d 84 (D.C.Cir. 1975), we

explained that "the Commission may attach precedential, and even controlling weight to principles developed in one proceeding and then apply them under appropriate circumstances in a stare decisis manner." *Id.* at 89. In that case, however, the Commission's decision to attach such weight to a prior proceeding was remanded, because

> a rudimentary prerequisite to such an application is that the factual composition of the case to which the principle is being applied bear something more than a modicum of similarity to the case from which the principle derives. This is not to say that factual patterns must be virtually identical for a principle to control, but rather that there is a point where the patterns are so diverse that a per se application of the principle, without at least recognition and accommodation of the factual distinctions, brings into question the rationality of the application.

Id. Given the importance of a utility's financial condition to the balancing required of the Commission, and Jersey Central's willingness to accept smaller revenues in order to record higher earnings so as to maintain that integrity, Jersey Central must have thought, as we do, that it had presented allegations that required reasoned examination, not summary dismissal in reliance on a precedent dealing with vastly different facts.

Trailblazer Pipeline Co., 18 F.E.R.C. (CCH) ¶ 61,244 (Mar. 12, 1982), presented Jersey Central with some additional grounds for believing that the Commission would take a more flexible approach. While the procedural posture was different—this was not a rate filing, but a proceeding brought to obtain Commission certification to construct and operate a gas pipeline—the Commission discussed in its opinion what rate treat-

ment would be accorded gas projects in the event of abandonment. When prudent, conventionally-financed projects were cancelled, the Commission indicated that the company would be able to recover debt service and a return of, but not on, the equity portion of the investment. *Id.* at 61,502–03. The Commission explained in a footnote:

> The rationale is that while companies should be able to recover the amount of their investment in failed projects, they should not be allowed to profit from their failures. Correlatively, loss of the time value of their equity in failed projects represents a reasonable sharing with ratepayers of the losses of a failed project.

Id. at 61,511 n. 17. The application of these principles to electric utilities was suggested by the Commission's statement that "[t]here is no obvious reason why the treatment of abandoned plant costs as between gas and electric companies should differ." *Id.* at 61,511 n. 15. And though this statement was made in a context where electric companies are treated more generously than gas companies, *see id.* at 61,511 & n. 15, the clear implication was that treatment of the two should in every sense be the same. Given *Trailblazer's* holding that gas companies would be able to recover debt service and a return of, but not on, the equity portion of the investment, *id.* at 61,502–03, this statement strongly suggests that the Commission would also consider extending the same treatment to electric companies.[6]

[6] In our discussion of *Trailblazer* in *Jersey Central I*, 730 F.2d at 820, we stated that "the treatment accorded the pipelines, if applied here, would not permit Jersey Central to recover its equity investment, the debt, the carrying charges on the debt, and the preferred stock costs." We were in error. While project-financed pipelines were to waive their right to recover the equity investments, the Commission expressly distinguished conven-

(footnote continued on next page)

The proposed pipeline in *Trailblazer* was financed through project financing. The discussion of conventionally-financed projects was not, however, *dicta*. The Commission was presenting Trailblazer Co. with a choice between conventional and project financing, and explaining the consequences of each alternative. The Commission was offering to be bound by the rule it laid down for conventional financing if Trailblazer elected to proceed in that fashion. *Trailblazer's* discussion of "Commission policy with respect to abandoned plant," 18 F.E.R.C. (CCH) at 61,501, plausibly led Jersey Central to believe that what the intervenors and the dissent characterize as a well-established rule in fact was open to further evolution. Indeed, the Commission's discussion of the question (published two weeks before Jersey Central made its filing) was prompted by its recognition that "Commission treatment of the issue of abandoned plant in rate proceedings has been uncertain. In fact, it has been characterized by a somewhat distressing degree of inconsistency. That inconsistency is important because it tends to leave both lenders and equity investors with a sense of uncertainty. . . ." *Id.*[7]

tionally-financed pipelines in its discussion on the ground that conventionally-financed pipelines involve a higher risk of shareholder exposure to loss, thus suggesting that the latter will not be required to waive their right to recover the equity investments. 18 F.E.R.C. (CCH) at 61,503–04. And recovery of the remaining costs would be allowed on the theory that the loss of a return *on* (not *of*) common equity would constitute the company's share of the burden imposed by the cancellation.

[7] This lingering uncertainty about what the intervenors and the dissent so confidently label a "rule" is indicated also by the fact that the Commission's policy, which as we have shown has never been clear or settled, is still in a state of flux. The Commission has now initiated a rulemaking proceeding in order to consider the establishment, for the first time, of a genuine rule with respect to the treatment of cancelled plants. *See* 31 F.E.R.C. (CCH) ¶ 61,376 (June 28, 1985); Regulation of Electricity Sales-for-Resale and Transmission Service, 50 Fed.Reg. 27,604, 27,612–14 (1985).

The intervenors' and the dissent's characterization of Jersey Central's filing as an intentional deviation from the Commission's "rules" is an unreasonable one. There was no reason for the company to adopt a suicidal course and it is wrong to impute an intent for which there is no evidence. This characterization is particularly unfair since, under that analysis, one must read into the filing an implied waiver of statutory and constitutional rights. Jersey Central was not mounting a frontal assault on a firm rule. To the contrary, it argued throughout the proceedings below that the cases in which the practice had developed were not similar enough to what was now at issue to warrant their application as dispositive precedent, and that recently articulated Commission policy and the threat in Jersey Central's situation to the investor interests that the Supreme Court had deemed protected required some consideration more detailed than that given by summary dismissal.[8]

B.

Essential to the intervenors' and the dissent's analysis is the assertion that Jersey Central had other means of getting the hearing it sought. It is only by positing alternative filings through which Jersey Central would have received a hearing on financial integrity that the intervenors and the dissent are able to place the responsibility for what occurred on the utility. Quite clearly,

[8]As the dissent notes, it is clear that Jersey Central did not structure its filing to conform to *Trailblazer*. Dissent at 1201. Yet it did rely heavily on *Trailblazer* in its argument for rehearing before the Commission, as well as in its arguments before the first panel, second panel, and *en banc* panel of this court. *See, e.g.*, Initial Brief of Jersey Central *passim*. In any event, the more important point is simply that *Trailblazer* offers further evidence of the uncertainty that surrounds this issue and belies any characterization of the Commission's practice as a rigid rule.

the Commission may not maintain a system of rules that provides no opportunity at all for *Hope* allegations to be raised, heard, considered, and made the subject of findings. Yet that opportunity is precisely what the Commission tells us it routinely denies. For this reason, too, the intervenors' and the dissent's argument fails.

As noted earlier, *supra* p. 1179, the Commission in its brief will say only that it "*may* also look to the criteria of *Hope* in determining whether its rate order is just and reasonable." There is in that no promise of a *Hope* hearing under any circumstances; only a declaration that one is not required.

The following exchange from the *en banc* oral argument further illuminates the Commission's belief that it owes no one a hearing on *Hope* issues:

> COURT: Suppose everything else in this case were the same, you would apply the NEPCO rule, et cetera, but the utility came in with even stronger showing and they came in and showed that if this rate went into effect, by God, they would be the first utility in the history of American utilities to go into actual bankruptcy or—
>
> COUNSEL: I think there is no—
>
> COURT: Let me finish the question.
>
> COUNSEL: All right.
>
> COURT: If that kind of showing were made, do you think that the Commission under Hope Natural Gas had a responsibility to, despite the fact that it applied some general rules, to look at the situation and say, gee, the end results are pretty scary and maybe we had better do some fooling around with—
>
> COUNSEL: I think the answer is yes, Your Honor, and it reminds us of the—

COURT: Well, my second question then is do you, and, if so, how? In most cases that are close, a little closer than that, do you do anything comparable at the end of the day after you have applied the NEPCO and other rules, to look back over your shoulder and say this is the situation, we ought to do some tinkering around and, if so, *do you make any such findings?*

COUNSEL: The answer to the question is yes, we do tinker around after we pursue these normal ratemaking policies. And the tinkering around or making those pragmatic adjustments, the nice adjustments is the way the Commission has in the past viewed its responsibility under the end result test—

COURT: *Do we ever know, do we—*

COUNSEL: *No, you don't. As long—*

COURT: *We don't know whether you did that or not?*

COUNSEL: *It essentially turns on the rate of return, the tinkering with the rate of return.*

Tr. at 28-30 (emphasis added). The Commission's apparent practice of taking these issues into account by "tinkering" and without making open, factual findings follows quite naturally from its mistaken premise that meaningful judicial review of these decisions is never, or almost never, in order. For us to hold now that Jersey Central could have had its *Hope* claim considered had it made a different filing would be to rest upon a theory that the Commission has never put forward, indeed, a theory the Commission apparently has rejected.

The only constant in these proceedings has been the Commission's manifest hostility to serious "end result" examination under *Hope*. That alone can account for the

Commission's peremptory ruling on the merits. That hostility, and not the Commission's desire, made clear only in this proceeding, to elevate its used-and-useful principle to the status of an impregnable barrier, appears to underlie the Commission's abrupt and uninformative procedural rulings. At the time of Jersey Central's filing, counsel could well have concluded that used-and-useful was a rule of thumb that would be modified when circumstances warranted. But if the Commission wished to eliminate its previous circumstance-bound enunciation of the rule and to make it universal and unyielding, it should have allowed Jersey Central to get to the merits of its *Hope* "end result" claim in some other way. Instead, it met each of Jersey Central's renewed efforts with a fresh procedural rebuff and never once gave the slightest indication of how Jersey Central could get the hearing it sought.

The intervenors and the dissent suggest that Jersey Central could have requested a shorter amortization period, perhaps the period allowed in *NEPCO*, and received higher rates through that method. That technique would have been of little help, however, for while it would have led to quicker, higher *revenues*, Jersey Central needed to record *earnings* in order to lay a foundation for the issuance of securities and regain access to the capital markets. That could not be done through faster recovery of costs.

The intervenors and the dissent also state that Jersey Central could have requested a higher rate of return, and, had it done so, would have received the *Hope* hearing it wanted. Given the excerpt we have quoted from oral argument, it is impossible to know why they believe that to be true. Nothing the Commission has

said provides any such assurance. To the contrary, when Jersey Central suggested a higher rate of return in its petition for rehearing, the Commission dismissed the request as presenting a "moving target." That maneuver was particularly pointless since it would merely have required the company to come back with a new filing requesting the same higher rate of return based upon the same data. The Commission thus saved no effort of its own but cost the company the higher return in the interval. (Of course, in the same order the Commission made it clear that a fresh filing would be futile.) The Commission could have entertained the company's request for a higher rate of return. Given the very unusual circumstances here, which may have amounted to a denial of constitutional rights, that course would not have jeopardized deployment of the "moving target" doctrine in the ordinary case.

The Commission has yet to articulate anything approaching a coherent conception of what *Hope* requires, when hearings and findings are necessary, which facts are relevant, or how judicial review of rate orders should proceed. It is clear that the Commission would not have granted Jersey Central a *Hope* hearing if the company had somehow anticipated and followed every one of the dissent's freshly-invented prescriptions. The Commission below and its counsel here have said as much. It is, therefore, preposterous to contend that the Commission's multiple failures with respect to the "end result" test were caused, and hence excused, by Jersey Central's alleged procedural intransigence.

IV.

The Commission is not precluded from employing "used and useful," or any other specific rate-setting for-

mula. It must ensure, however, that the resulting rate is just and reasonable. A remand will afford the Commission the opportunity to find the facts necessary to a determination of whether the rate order meets the requirements *of Hope Natural Gas*, and, if it finds that it does not, the Commission has the flexibility to determine how the rate order should be modified—whether through enlarging the rate base, increasing the rate of return, or a combination of both. That will fulfill its obligations under the law.

So Ordered.

STARR, Circuit Judge, concurring:

Although I agree with my dissenting colleagues that Jersey Central has mounted an ill-conceived and overly broad attack on the "used and useful" principle, *see* Dissenting Opinion at 1197, I am satisfied that under the circumstances presented this case must be returned to the Commission. For the reasons that follow, I concur in the opinion of the court and in the decision to vacate and remand the Commission's orders.

I

The Commission has acted cavalierly in this case. As the court's opinion persuasively demonstrates, the Commission failed to take seriously the allegations of severe financial plight confronting Jersey Central. Its discussion of that plight is intolerably terse. In its order to reconsideration, the Commission stated that no testimony or exhibits had been proffered to justify a higher return. Yet the allegations of financial plight were highly detailed and specific, indicating that the utility was skating on the edge of bankruptcy.

The Commission's stated justification for summarily dismissing these allegations was the weight of its prior "used and useful" precedent. But as the court's opinion shows, that body of precedent did not constitute as ironclad a rule as the Commission would have us believe. It is certainly not evident from those precedents that the rule could be summarily applied in the face of the financial demise of the regulated entity.

Indeed, the Commission as a matter of policy has departed over the years from the strictures of the "used and useful" rule. This is illustrated by its treatment of "construction work in progress" (CWIP), part of which, the Commission recently determined, can be included in a utility's rate base. *See Mid-Tex Electric Corporation v. FERC*, 773 F.2d 327 (D.C.Cir.1985). In that proceeding, the Commission recognized that its own practice admits of "widely recognized exceptions and departures" from the "used and useful" rule, particularly when there are countervailing public interest considerations." *See* 48 Fed.Reg. 24,323, 24,335 (June 1, 1983) (CWIP final rule). In that setting, financial difficulties in the electric utility industry played a significant role in the Commission's decision to bend the rule. *See id.* at 24,332; 773 F.2d at 332-34. *See also, e.g., Tennessee Gas Pipeline Co. v. FERC*, 606 F.2d 1094, 1109-10 (D.C.Cir.1979) (departure from "used and useful" to permit rate base treatment of natural gas prepayment is justified as means of encouraging development of additional gas reserves), *cert. denied*, 445 U.S. 920, 100 S.Ct. 1284, 63 L.Ed.2d 605 (1980).

This policy of flexibility, it seems to me, reflects the practical reality of the electric utility industry, namely that investments in plant and equipment are enormously costly. Rigid adherence to "used and useful" doc-

trines would doubtless imperil the viability of some utilities; thus, while not articulating its results in *Hope* or "takings" terms, the Commission—whether as a matter of policy or perceived constitutional obligation—has in the past taken these realities into account and provided relief for utilities in various forms.

What the Commission now confronts in Jersey Central's rate filing is an investment, prudent when made, in a nuclear power facility that was doomed to failure. The cost of that project prior to abandonment was enormous—$397 million. Under these circumstances, the Commission, in order to engage in reasoned decisionmaking, has a duty to consider the entire financial circumstances confronting the utility, as it did in the CWIP context, not to rely blindly on precedents which do not involve similarly situated utilities facing the most dire financial consequences. Should the Commission nonetheless choose to adhere to the "used and useful" principle in these circumstances, it must provide a reasoned explanation for that decision. "Judicial review of the Commission's order [ ] will . . . function accurately and efficaciously only if the Commission indicates fully and carefully the methods by which, and the purposes for which, it has chosen to act, as well as its assessment of the consequences of its order [ ] for the character and future development of the industry." *Permian Basin Area Rate Cases*, 390 U.S. 747, 792, 88 S.Ct. 1344, 1373, 20 L.Ed.2d 312 (1968). It is scarcely reasoned decisionmaking to dismiss out of hand allegations that go to the heart of the utility's financial viability.

II

The Commission's arbitrary and capricious treatment of the issues presented by Jersey Central necessitates

the return of this case for further proceedings. The specific questions on remand will be whether the Commission's treatment of Jersey Central's request is consistent with prior precedent and whether the rate order entered in this instance violates *Hope*'s "end result" test. To address the latter question, it will be necessary to take into account the constitutional considerations at stake, namely whether the rate order or any other agency action which preceded that order worked a "taking" within the compass of the Fifth Amendment's Takings Clause. Those would appear to be novel issues for a Commission that seems determined to avoid an "end result" inquiry as such, while at the same time making various adjustments to bring relief to troubled parts of the electric utility industry. Under these circumstances, a comment or two is in order as to why I have concluded that, notwithstanding the Commission's agnosticism, Jersey Central's complaint "sounds" in the constitutional demands of the Fifth Amendment. Whether the facts would indeed make out a constitutional violation is obviously not before us, Majority Opinion at 1174, and must await the *Hope* mandated hearing which must now be held.

The utility business represents a compact of sorts; a monopoly on service in a particular geographical area (coupled with state-conferred rights of eminent domain or condemnation) is granted to the utility in exchange for a regime of intensive regulation, including price regulation, quite alien to the free market. *Cf. Permian Basin*, 390 U.S. at 756–57, 88 S.Ct. at 1354–55 (unlike public utilities, producers of natural gas "enjoy no franchises or guaranteed areas of service" and are "intensely competitive"). Each party to the compact gets something in the bargain. As a general rule, utility in-

vestors are provided a level of stability in earnings and value less likely to be attained in the unregulated or moderately regulated sector; in turn, ratepayers are afforded universal, non-discriminatory service and protection from monopolistic profits through political control over an economic enterprise. Whether this regime is wise or not is, needless to say, not before us. *See generally* Posner, *Natural Monopoly and Its Regulation*, 21 Stan.L.Rev. 548 (1969); Demsetz, *Why Regulate Utilities?*, 11 J. Law & Econ. 55 (1969).

In the setting of rate regulation, when does a taking from the investors occur? It seems to me that it occurs only when a regulated rate is confiscatory, which is a short-hand way of saying that an unreasonable balance has been struck in the regulation process so as unreasonably to favor ratepayer interests at the substantial expense of investor interests. Thus, in my view, a taking does not occur when financial resources are committed to the enterprise. That is especially so since a utility's capital investment is made not simply in satisfaction of legal obligations to provide service to the public but in anticipation of profits on the investment. The utility is not a servant to the state; it is a for-profit enterprise which incurs legal obligations in exchange for state-conferred benefits. A profit-seeking capital investment is scarcely the sort of deprivation of possession, use, enjoyment, and ownership of property which can conceptually be deemed a taking. *See generally* R. Epstein, *Takings* 63–92 (1985). Indeed, it would seem odd to consider as a taking government's disavowal of any interest in property which remains unregulated and which reflects a profit-seeking investment.

It is also of significance to the constitutional inquiry whether the regulators forbade completion of construc-

tion. *Cf. In re Public Service Co.*, 122 N.H. 1062, 454 A.2d 435 (1982) (holding that under the New Hampshire constitution, the State cannot prevent completion of construction of the Seabrook nuclear power facility without providing just compensation). *But see Penn Central Transportation Co. v. City of New York*, 438 U.S. 104, 98 S.Ct. 2646, 57 L.Ed.2d 631 (1978) (New York City historic preservation law employed to forbid development of office building). It would seem that, at least conceptually, a taking of investment funds in the Forked River project would have occurred if government so regulated as to prevent the property, in whole or in part, from being employed in the manner desired by the owner. But as we know, these conditions did not occur.

Nor would a taking (*pro tanto*) automatically occur when regulation itself takes place, for that was part of the original compact between investors and the state. Rate regulation is, in theory, the substitute for competition. The state stands in the shoes, as it were, of competitors, keeping the utility within bounds that would be drawn by market forces in a non-monopolistic market. Whether economically sound or not, utility rate regulation in itself raises no constitutional concerns.

Under one line of analysis, inclusion of prudent investments in the rate base is not in and of itself exploitative. *See Washington Gas Light Co. v. Baker*, 188 F.2d 11 (D.C.Cir.1950), *cert. denied*, 340 U.S. 952, 71 S.Ct. 571, 95 L.Ed. 686 (1951). I am not so sure that such an easy rule can automatically be properly employed consistent with the demands of the Fifth Amendment. Prudence is, of course, relevant to the process of striking a reasonable balance in rate-setting for public utilities. Requiring an investment to be prudent when made is one safeguard imposed by regulatory authorities upon

the regulated business for benefit of taxpayers. As I see it, the "used and useful" rule is but another such safeguard. The prudence rule looks to the time of investment, whereas the "used and useful" rule looks toward a later time. The two principles are designed to assure that the ratepayers, whose property might otherwise of course be "taken" by regulatory authorities, will not necessarily be saddled with the results of management's defalcations or mistakes, or as a matter of simple justice, be required to pay for that which provides the ratepayers with no discernible benefit.[1]

The two principles thus provide assurances that ill-guided management or management that simply proves in hindsight to have been wrong will not automatically be bailed out from conditions which government did not force upon it. That is, government forced upon the utility an obligation to provide service, but that obligation, as we have seen, is the *quid pro quo* for a protected area of service (and eminent domain authority). What is fundamental is that government did not force upon the utility a specific course of action for achieving the mandated goal.

Indeed, it would be curious if the Constitution protected utility investors entirely from business dangers experienced daily in the free market, the danger that managers will prove to have been overly sanguine about business prospects or the danger that a particular capital investment will not prove successful. In the face

[1]The obvious danger in not examining both ends of the continuum—both the prudence of the investment and whether the end result of the investment was used and useful—is to build in pressures for building excess generating capacity. The "used and useful" rule operates as a restraining principle, reminding utility managers that they must assume the risk of economic forces working against an investment which is prudent at the time it is made.

of anticipated demand, an airline may acquire additional aircraft, only to face unhappy consequences when passenger traffic does not meet expectations, perhaps due to economic factors entirely beyond management's control. Utilities are not exempt from comparable forces.[2] As the cases have repeatedly held, the Fifth Amendment does not provide utility investors with a haven from the operation of market forces. *See, e.g., FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 590, 62 S.Ct. 736, 745, 86 L.Ed. 1037 (1942) ("[R]egulation does not insure that the business shall produce net revenues."). Yet, the prudent investment rule, in full vigor, would accomplish virtually that state of insulation, all in the guise of preventing government from effecting a taking without just compensation.

For me, the prudent investment rule is, taken alone, too weighted for constitutional analysis in favor of the utility. It lacks balance. But so too, the "used and useful" rule, taken alone is skewed heavily in favor of ratepayers.[3] it also lacks balance. In the modern setting,

[2]The comparison is, of course, imperfect since the airline will enjoy the full fruits of financial success if its acquisition program succeeds. A utility's rate of return, in contrast, is limited by regulation. On the other hand, the airline is not provided with the protection of a regulatory body's interest in preserving the financial soundness of the enterprise.

[3]I recognize that venerable authority supports firm adherence to "used and useful" precepts. In *Denver Union Stock Yard Co. v. United States*, 304 U.S. 470, 58 S.Ct. 990, 82 L.Ed. 1469 (1938), for example, the Supreme Court (in an opinion joined by Justice Brandeis, the leading proponent of the prudent investment approach) embraced the "used and useful" rule in the following language:

> *The rate base.* As of right safeguarded by the due process clause of the Fifth Amendment, appellant is entitled to rates, not *per se* excessive and extortionate, sufficient to yield a reasonable rate of return upon the value of property used, at the time it is being used, to render the services. *But it is not entitled to have included any property not used and useful for that purpose.*

(footnote continued on next page)

neither regime, mechanically applied with full rigor, will likely achieve justice among the competing interests of investor and ratepayers so as to avoid confiscation of the utility's property or a taking of the property of ratepayers through unjustifiably exorbitant rates. Each approach, however, provides important insights about the ultimate object of the regulatory process, which is to achieve a just result in rate regulation. And that is the mission commanded by the Fifth Amendment. Unlike garden-variety takings, the requirements of the Takings Clause are satisfied in the rate regulatory setting when justice is done, that is to say the striking of a reasonable balance between competing interests.

Thus it is that a taking occurs not when an investment is made (even one under legal obligation), but when the balance between investor and ratepayer interests—the very function of utility regulation—is struck unjustly. Although the agency has broad latitude in striking the balance, the Constitution nonetheless requires that the end result reflect a reasonable balancing of the interests of investors and ratepayers. As we have seen, both investors and ratepayers were the intended beneficiaries of the Forked River investment; both should presumptively have to share in the loss.[4] Filling in the gaps, the making of the specific judgments

Id. at 475, 58 S.Ct. at 994 (citations omitted) (emphasis added). But it seems to me that this language was not meant to state an absolute and unchanging constitutional rule regardless of the nature of the investment and the impact of the rate order. The Court's subsequent teaching in *Hope* makes it clear that no specific methodology is either inherently infirm or sacrosanct.

[4]In like manner, a regulatory order requiring ratepayers to pay monopolistic prices would fail to achieve the constitutionally required balance of interests. That sort of order would work a taking of ratepayers' property, assuming the public purpose requirement of the Takings Clause had been met.

that constitutes the difficult part of this enterprise, belongs in the first instance to the politically accountable branches, specifically to the experts in the agency, not to generalist judges.

It is here that *Hope's* "end result" test comes into play. The judiciary is not to micromanage the rate regulation process, just as we are to be restrained in reviewing the other work of administrative agencies. We are not to impose procedures that we think are wise or methodologies that we think strike a better balance than that struck by the regulators. Our limited but vital role is to ensure that the end result of a rate order reasonably balances investor and ratepayer interests.

We are, fortunately, not left completely in a web of subjectivity in making these judgments. To be sure, Takings Clause law has not been marked by analytical consistency, as Professor Epstein has brilliantly demonstrated in his recent book. Nor has it been characterized, as much as we might care for them, by bright-line rules. In the words of then-Justice Rehnquist speaking for the Court in *Kaiser Aetna v. United States*, 444 U.S. 164, 175, 100 S.Ct. 383, 390, 62 L.Ed.2d 332 (1979), the inquiry is "essentially ... ad hoc [and] factual" in nature. Nonetheless, we have been taught that several factors are worthy of consideration in determining whether regulation works a taking, including "the economic impact of the regulation, the extent to which it interferes with investment-backed expectations, and the character of the governmental action." *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 432, 102 S.Ct. 3164, 3174, 73 L.Ed.2d 868 (1982); *see also PruneYard Shopping Center v. Robins*, 447 U.S. 74, 83, 100 S.Ct. 2035, 2041, 64 L.Ed.2d 741 (1980); *Kaiser Aetna*, 444 U.S. at 175, 100 S.Ct. at 390.

While it is premature to pass ultimate judgment on the question, some preliminary observations are in order. The first of the three considerations enumerated in Supreme Court decisions points powerfully in favor of Jersey Central. Forked River represents an enormous loss, and the very enormity of it must weigh heavily in the balance. No one maintains that exclusion of the abandoned plant from the rate base is *de minimis*, not affecting the return on property. *Cf. Loretto*, 458 U.S. at 445, 102 S.Ct. at 3181. (Blackmun, J., dissenting); *PruneYard*, 447 U.S. at 83, 100 S.Ct. at 2041. To the contrary, Jersey Central represents that it is perilously close to the edge of bankruptcy, unable to secure long-term credit, and unable to attract capital to the enterprise.

The second consideration—the extent to which the agency's action interferes with investment-backed expectations—is mixed. As a general rule, it would appear that investors purchase utility stock as a mechanism for conservative, safe investments. Drobak, *From Turnpike to Nuclear Power: The Constitutional Limit on Utility Rate Regulation*, 65 B.U.L.Rev. 65, 106–107 (1985). Potentially high rewards are foresworn in favor of stability and safety. And now the situation of Jersey Central's investors is grim. There is no prospect, we are told, for those investors to earn a return on their investment. Thus, in holding over strenuous dissents that no taking was occasioned by New York City's interference with Penn Central's plans to erect an office building atop Grand Central Station, the Supreme Court emphasized that the property owner could still earn a reasonable return on the investment notwithstanding the restrictive effects of the historic preservation law.[5] Jersey Central's

[5]Needless to say, this analysis does not respond to the objection that a *partial* taking, as opposed to a complete deprivation of property, was being effected.

investors have nothing but bleak days ahead, we are told, unless regulatory relief is forthcoming.[6]

On the other hand, FERC has already moved somewhat in the direction of balancing competing interests by permitting recovery of the costs of building the plant in the cost of service. Investor interests have not, therefore, been entirely ignored. In addition, as I indicated above, utilities are not shielded by the Constitution from the forces of competition and the uncertainties of economic life, and investors purchasing common stock are after all engaged in economic risk-taking. In addition, it surely cannot be reasonable for an investor to assume that each and every expenditure by a utility will be allowed by regulatory authorities. The very existence of regulation carries with it the hard fact that not every rate increase will be granted, not every expenditure will be allowed. Yet, "reasoned consideration" of investor interests requires more than the mechanical application of everyday rules to the loss of a $397 million investment in a power plant. *Permian Basin*, 390 U.S. at 792, 88 S.Ct. at 1373.

Finally, the character of the government action weighs for takings analysis in favor of the agency. The classic taking is when government invades and possesses property, partly or entirely. Permanent physical occupation provides the clearest example. *United States v. Lynah*, 188 U.S. 445, 468–70, 23 S.Ct. 349, 356–57, 47 L.Ed. 539 (1903). Occupation can, of course, be partial,

[6]It also goes without saying that Jersey Central's rate woes cannot in any event be laid entirely at the feet of FERC. It appears that state regulatory authorities, whose orders have considerably greater economic effect on Jersey Central than federal directives, have been inhospitable to efforts to include the Forked River plant in the state-regulated rate base. If that is so, relief from Draconian regulation in Trenton cannot come from Washington, D.C.

and the taking can be the consequence of a private invasion if accomplished under the state's auspices. *Loretto*, 458 U.S. 419, 102 S.Ct. 3164, 73 L.Ed.2d 868 (1982). A taking can occur when government imposes a right of access on private property, at least when the landowner had reasonably relied on government consent in making the improvements that purportedly opened the property to uninvited outsiders. *Kaiser Aetna*, 444 U.S. 164, 100 S.Ct. 383, 62 L.Ed.2d 332 (1979). The latter case teaches that the elimination of a basic incident of ownership—the right to exclude unwanted visitors from property—can constitute a taking. And, while the issue was sharply disputed in the Court and the resolution seemingly in conflict with *Kaiser Aetna*, it appears from the *PruneYard* case that the conduct of the landowner is of relevance in the constitutional analysis. That case teaches that willfully surrendering one of the "bundle" of property rights may result in greater, state-protected intrusion by outsiders than the property owner intended. Specifically, a shopping center owner may find that individuals may be permitted, over his objection, to exercise certain noncommercial rights on the shopping center property.[7] *PruneYard*, 447 U.S. at 83, 100 S.Ct. at 2041. Thus, in contrast to *Kaiser Aetna*, the owner of the PruneYard Shopping Center found that he had lost the right to exclude some visitors by issuing an invitation to the public generally to visit the center for commercial purposes.[8]

[7]Like *Penn Central*, this analysis does not squarely address the argument that a *pro tanto* taking has occurred, which, as *Kaiser Aetna* taught, demands compensation under the Takings Clause.

[8]Whatever its analytical strengths, the *PruneYard* opinion took pains to emphasize the limited nature of the intrusion by the petition-seekers. Surely the commercial invitation of the PruneYard center's owner would not permit a political candidate to set up campaign operations in the mall's

(Footnote continued on following page)

The nature of the government action in this case obviously seems unintrusive in contrast to more typical takings cases. There has been no invasion, temporary or permanent. As I have previously indicated, the regulatory entity has not forbidden the Forked River project to proceed. What government has done is to forbid the investment to garner a return, thus balancing competing principles of utility regulation. Forbidding a profit on an investment gone sour strikes me, conceptually, as recreating in part the marketplace environment; indeed, FERC's permitting recovery of the investment itself through cost of service works an interference with what would otherwise occur in the unregulated setting, since the investors as risk takers would obviously bear the entire risk that the investment would not pan out. In addition, FERC's obligation to consider consumer needs and expectations must be evaluated in determining whether its order arbitrarily limited the return to investors. *Permian Basin*, 390 U.S. at 769, 88 S.Ct. at 1361 ("[I]nvestors' interests provide only one of the variables in the constitutional calculus of reasonableness.").

But it is not for us to finally resolve these questions in the first instance. That job, as I have said, belongs to regulators, not judges. *See Permian Basin*, 390 U.S. at 792, 88 S.Ct. at 1373. In my view, this case must now be resolved by the Commission, facing up to the hard question of whether, under all the circumstances, a violation of *Hope* has been worked by this rate order. That determination, it seems to me, can only be made by a careful balancing of the competing considerations that are inevitably present in the setting of utility

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common areas, or for the mall to serve as a makeshift lecture hall on foreign policy or a practice field for the local marching band on rainy days.

regulation. *Id.* While I am unable to pass judgment on the ultimate issue in this case, I am convinced that FERC has completely failed to come to grips with the question and that the question is now squarely before it for resolution.

MIKVA, Circuit Judge, with whom Chief Judge WALD, and Circuit Judges SPOTTSWOOD W. ROBINSON, III and HARRY T. EDWARDS join, dissenting:

After two prior opinions, confounded by the Commission's ever-shifting position, it is small wonder that this court is having difficulty seeing the forest for the trees. In its attempt to beat a clear path to resolution of the issues, however, the majority treads with heavy foot over some well-held doctrines regarding takings, unreasonableness of return, and the obligation of the Federal Energy Regulatory Commission (the Commission or FERC) to guarantee the financial solvency of a utility. Perhaps the greatest damage is rendered by the implications of the majority opinion for the scope of judicial review of Commission ratemaking procedures. Although we believe the Commission has been less than forthright in defending its action, we cannot join in the havoc our colleagues have wreaked in order to slap its hands.

The ramifications of today's decision are inescapably broad. Whenever a utility files a proposed rate schedule and alleges that the revenues and earnings contemplated produce the "minimum amount" necessary for it to have access to capital markets and to maintain its financial integrity, the Commission is constrained to take no interim rate-reducing action without first holding a hearing and making findings pursuant to the test

formulated in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1944). The majority reads *Hope* as authorizing the court to direct FERC, when faced with such allegations, to abandon its otherwise permissible summary disposition procedures. This holding constitutes a blatant interference with the ratemaking procedures adopted by the Commission. Such intrusion into the Commission's authority would have been deemed outrageous even in the days before *Vermont Yankee Nuclear Power Corp. v. Natural Resources Defense Council, Inc.*, 435 U.S. 519, 98 S.Ct. 1197, 55 L.Ed.2d 460 (1978). We cannot believe that it is unobjectionable in this age of judicial deference. Therefore, we respectfully dissent.

I. Background

A full appreciation of the impact of today's decision requires an understanding of the posture in which this case comes to us. At an intermediate stage of the ratemaking proceeding, the Commission summarily rejected a non-conforming portion of Jersey Central's filing pursuant to longstanding policy and procedure. Jersey Central loudly complained and refused to go further with the ratemaking process. In rushing headlong into the *Hope* issue, the majority loses sight of what we have here—Jersey Central is attempting to convert its rate case into a rulemaking proceeding. The majority allows the utility to succeed. It responds to Jersey Central's complaints by directing FERC to abandon agency rules as applied to the utility and to implement the utility's rates according to procedures the Commission would not normally follow.

On March 31, 1982, Jersey Central Power and Light Company (Jersey Central) filed a proposed two-phase

increase in its rate schedules for six wholesale customers. Phase A has gone into effect and is not at issue here. In Phase B, the utility proposed to amortize over 15 years a $397 million investment lost when it abandoned construction of a nuclear power plant project at Forked River, New Jersey. That is, Jersey Central sought to recover the project expenditure from its ratepayers as costs over time. It also sought to include in its rate base the current carrying charges (computed at 5.2%) on the debt and on the preferred stock portions of the unamortized investment in the plant. The total return a public utility captures is, simply put, the product of its permitted rate base and rate of return. Thus, the inclusion of the desired items in the rate base would generate a return on them over the amortization period; current ratepayers would bear the cost. The exclusion of these items from the rate base would require Jersey Central's common equity investors to bear a financial burden; they would not obtain a return on the investment and would pay current charges.

Jersey Central's wholesale customers protested the increased rates tendered for filing and petitioned the Commission to intervene in the ratemaking proceedings. Among other requests, the wholesalers moved for a partial rejection of the second phase of the rate filing. Adhering to its policy regarding abandoned investments, the Commission granted the wholesalers' motion for summary disposition of the rate base inclusion of the unamortized investment in the cancelled plant. Under settled FERC policy, expenditure for an item may be included in a public utility's rate base only when the item is "used and useful" in rendering service to the ratepayers. Accordingly, the Commission's interim order allowed amortization of the Forked River in-

vestment as requested, but required Jersey Central to exclude the unamortized items from its rate base. 19 FERC (CCH) ¶ 61,208 (May 28, 1982).

In ordering this exclusion, FERC relied on *New England Power Co.*, 8 FERC (CCH) ¶ 61,054 (July 19, 1979), *aff'd sub nom. NEPCO Municipal Rate Committee v. Federal Energy Regulatory Commission*, 668 F.2d 1327 (D.C. Cir.1981), *cert. denied*, 457 U.S. 1117, 102 S.Ct. 2928, 73 L.Ed.2d 1329 (1982) ("*NEPCO*"). *NEPCO* held that utilities could amortize the full investment loss suffered from abandoned projects, but could not include the unamortized portion of these investments in the rate base because the abandoned projects were not "used or useful." By following *NEPCO*, the Commission allowed Jersey Central to recover its total investment in the project to the point of cancellation, but denied the utility any return on the capital invested in the cancelled plant.

In concluding, the Commission ordered Jersey Central to file revised Phase B rates and cost support reflecting the summary disposition. The revision ordered would presumably be downward. Notably, because its preliminary review "indicate[d] that [the Phase B increase] may produce substantially excessive revenues," the Commission suspended implementation of Phase B and ordered that a public hearing be held "concerning the justness and reasonableness of [Jersey Central's] rates." 19 FERC (CCH) ¶ 61,208, at 61,404.

Jersey Central did not file the revised material ordered. Instead, on June 24, 1982, it applied for rehearing, requesting reconsideration of the summary disposition or, in the alternative, a higher rate of return than that originally proposed in order to compensate for its

diminished rate base. The Commission denied rehearing as to exclusion of the investment in the cancelled nuclear facility from the rate base. It noted that its decisions since *NEPCO* had reaffirmed the exclusion of current charges on unamortized investments. *Jersey Central Power & Light Co.*, 20 FERC (CCH) ¶ 61,083, at 61,181 (July 23, 1982). In rejecting Jersey Central's alternative proposed approach, the Commission ruled that the company could not support its revenue request on rehearing simply "by inflating the rate of return to recover dollars equal to those attributable to its impermissible rate base inclusion." *Id.* at 61,182. Pursuant to settled policy, the Commission refused to consider increasing the rate of return when that alternative was raised in the first instance on application for review without supporting documentation. *See id.*

After the denial of rehearing, Jersey Central again failed to revise its filings. Had it done so, an Administrative Law Judge (ALJ) would have held a hearing, pursuant to the Commission's initial order, on the "justness and reasonableness" of the rates. At this hearing, the wholesalers could have intervened and presented their arguments that the rates, although reduced from those originally proposed, were nonetheless excessive. *See* 19 FERC (CCH) ¶ 61,208, at 61,404. Similarly, Jersey Central could have testified as to its belief that the reduced rates were too low.

Furthermore, the utility had two additional avenues open to it. First, Jersey Central could have refiled for a proposed rate increase after its application for rehearing was denied by operation of law. *See* 18 C.F.R. § 385.714(f) (1986). In pointing out the inadequacies of Jersey Central's initial filing, the Commission clearly left the way open for a *new* rate proceeding that would

include testimony and exhibits supporting a higher rate of return, as required by the Commission's rules. *See id.* § 35.13 (1986). In such a request the utility could have proposed a shorter amortization period than that it had initially requested or offered evidence of cost of service elements justifying a higher overall return on the remaining assets in the rate base. Second, Jersey Central could have petitioned the Commission for a rulemaking concerning the continued validity of the "used and useful" principle when applied to cancelled plants generally. *See generally* Administrative Procedure Act, 5 U.S.C. § 553(e) (1982). At the proposed rulemaking proceeding, Jersey Central could have presented testimony in support of its position that the Commission's present used and useful policy unnecessarily penalizes utility investors. *See* 18 C.F.R. § 385.505 (1986). Instead of pursuing either, or both, of these administrative alternatives, Jersey Central appealed to this court.

The majority seems to have lost sight of the juncture at which we stand in reviewing the Commission's orders. It is too anxious to reach the end of the road. The majority contends that the Commission "reached" and "wrongly dispatched" Jersey Central's *Hope* claim. Majority Opinion (Maj. Op.) at 1183; *see also id.* at 1170. Its reasoning runs as follows: "The Commission ruled that Jersey Central's allegations and proffered testimony would not support a higher rate. That substantive ruling means that a hearing would have been pointless." *Id.* at 1170. Although the Commission's interim order has implications for the utility's *Hope* claim, this construction is unfounded. Furthermore, it makes a mockery of the Commission's order to hold a hearing on the very issue of the justness and reasonableness of the revised rates.

Contrary to the majority's postulation, it is not the Commission's position that it need not make an "end result" examination. *See id.* Throughout its briefings and arguments before this court, the Commission has allowed that it must construct a rate within the confines of the "zone of reasonableness" informed by *Hope*. Rather, the Commission maintains that it need not hold a hearing to make that inquiry before it excludes a nonconforming element from a proposed rate base—at least not on the facts alleged here. The "end result" inquiry is made at the end of the ratemaking process, not at an intermediate, summary disposition stage. Thus, a hearing on inclusion of the unamortized portion of the cancelled plant in the rate base would be "pointless." A hearing on the resultant rates would not be. In fact, as counsel for FERC explained at oral argument, it was the post-appeal settlement adjusting Jersey Central's rate of return that obviated the need for the rate hearing ordered by the Commission.

No one disputes Jersey Central's right to have the end result of the ratemaking proceeding subjected to a *Hope* inquiry. The issue is one of timing. FERC provided for a hearing on the adequacy of the rates allowed Jersey Central *after* the Commission's reduction. The final rate order that emanated from that hearing would in any event be subject to judicial review. *See Hope, supra.* Jersey Central demands a hearing *before* the reduction—now, not at the end. No wonder the majority and separate opinions complain of not having a record through which to examine the Commission's effort to balance the relevant interests. Maj.Op. at 1172, 1178; Separate Opinion (Sep.Op.) at 1188–89. Jersey Central elected to forego a hearing on the reduced rates and instead chose to clamor to this court for review of

the Commission's actions taken before the final balancing was performed. It is an interim rate-reducing order of which Jersey Central seeks review, not a final rate-setting order. The majority's decision to yield to Jersey Central's demands directly implicates the Commission's ratemaking authority and its capacity to exercise its valid, established procedures free of judicial improvements.

The question this court addresses is the question that Jersey Central reserved its right to appeal under the settlement agreement: whether the Commission acted properly in limiting the rate base to used and useful property. As the majority recounts, Maj.Op. at 1173, Jersey Central's challenge to the Commission's orders takes three principal tacks. The utility first claims that the Commission has not established a used and useful rule applicable to its proposed filing. Second, the utility claims that, even if there were such a rule, application of the doctrine under the circumstances would lead to unconstitutionally confiscatory rates; therefore, it contends, the Commission cannot summarily apply the rule and must provide an evidentiary hearing. Finally, Jersey Central complains that, in the alternative, it is entitled to a hearing on an increased rate of return on its initial filing.

The majority finds that there is no iron clad rule regarding rate base treatment of cancelled electric utility plants and holds that Jersey Central is automatically entitled to a hearing on its proposed filing. Our inquiry leads us to the firm conclusion that the Commission acted reasonably and that Jersey Central is not entitled to a hearing on rate base treatment of the unamortized cost items of its rate schedule or on an inflated rate of

return. The Commission followed established agency rules and procedures and Jersey Central cannot complain. There may be times when FERC is not free to summarily apply settled doctrine during the ratemaking process, but Jersey Central has not presented such a case.

II. The Commission's Application of the Used and Useful Rule

At the heart of Jersey Central's complaint is its dislike of the used and useful principle, especially as elaborated in *NEPCO, supra*. In its attempt to have the Commission reconsider the doctrine, Jersey Central argues that the precedent does not, or should not, apply to it. Unlike the majority, we find that, in *NEPCO* and subsequent cases, the Commission firmly established a valid rule for the calculation of rate base in electric utilities' rate filings. Unmoved by Jersey Central's endeavors to distinguish itself, we conclude that the Commission's summary rejection in this case precisely follows that precedent.

It is, of course, widely accepted that the Commission may develop principles in one proceeding and then attach precedential of even controlling weight to them in later proceedings. *See, e.g., Michigan Wisconsin Pipe Line Co. v. Federal Power Commission*, 520 F.2d 84, 89 (D.C.Cir.1975). And the Commission can properly implement that policy, in order to protect consumers, at the summary judgment stage of its proceedings. *See Municipal Light Boards v. Federal Power Commission*, 450 F.2d 1341 (D.C.Cir.1971), *cert. denied*, 405 U.S. 989, 92 S.Ct. 1251, 31 L.Ed.2d 455 (1972). The majority seems to have no quarrel with this premise. Like Jersey Cen-

tral, however, it disputes that the Commission had developed a principle or rule against including the unamortized portion of an abandoned investment in the rate base. Although not the ground on which it remands the proceeding, the majority implies that the application of the used and useful doctrine to Jersey Central's rate schedule was inconsistent with any practice established by the Commission. *See* Maj.Op. at 1185–86. The majority's reasoning distorts the NEPCO precedent established by the Commission, contradicts this court's interpretation of the doctrine, and manipulates inapposite Commission decisions.

A. *The NEPCO Approach*

The majority asserts that rather than establishing a general policy in *NEPCO*, the Commission was engaging in a case-specific balancing of interests. *Id.* at 1183. The majority thus conceives the crucial factor underlying *NEPCO* as the reasonable balance that was struck by the Commission's compromise between the NEPCO rate-payers and investors. In its view, the *NEPCO* decision was as much dependent on the length of the amortization period, the percentage of costs the utility would be permitted to amortize, and the size of the investment as it was on the question of whether the unamortized portion of those costs should be included in the rate base. *Id.* Therefore, because Jersey Central proposed a different amortization period, presented a much larger investment and faced financial distress, a fact not alleged in *NEPCO*, the utility had substantially distinguished itself from *NEPCO*. *Id.* at 1184. Under the majority's interpretation, the Commission must strike a new reasonable balance between ratepayers and investors in this case and cannot do so through summary

adjudication. The majority's interpretation jibes with neither the Commission's nor this court's decision. Moreover, it virtually destroys any usefulness of *NEPCO* as a substantive rule of *policy*.

NEPCO concerned the used and useful principle in general, not just as applied to one cancelled plant. In *NEPCO*, we approved the Commission's policy against permitting a utility to reap a return on the unamortized portion of its investment in an abandoned generating station. This policy is based on a principle of ratemaking upheld long ago by the Supreme Court: a utility may not include in its rate base properties that are not "used and useful" in serving its ratepayers. *See Denver Union Stock Yard Co. v. United States*, 304 U.S. 470, 475, 58 S.Ct. 990, 994, 82 L.Ed. 1469 (1938). Thus, in *NEPCO* the Commission allowed the utility to recover the money it owed on a partially constructed and then cancelled generating plant, but not to receive a return on that investment over the amortization period. Abandoned projects are neither used nor useful and therefore properly can be excluded from the rate base. Only as a result of that standard did the Commission note that a reasonable balance had been attained.

The ALJ's decision and the Commission's adoption of it were based clearly—and exclusively—on the used and useful principle. In selectively cribbing from the Commission's quote of the ALJ opinion, the majority strives to create the impression that the decision was fact-based. *See* Maj.Op. at 1184. Nothing could be farther from the truth. In reaching his conclusion, the ALJ indicated that "[t]he equitable method of handling this issue requires a balancing of the interest of ratepayers and security holders." J.A. in *NEPCO*, 668 F.2d at 1332. In balancing these interests, the ALJ made no

mention of the amortization period, or the size of the investment, or any other specific fact. Nor did the Commission make mention of such facts in adopting the ALJ's findings. In rejecting NEPCO's argument that ratepayers should be required to pay a return on the expenditure related to an aborted project, the Commission simply quoted from (and thereby indicated its agreement with) the ALJ's determinations:

> Ratepayers are not required to insure that a utility receive a return on all monies invested in the enterprise; ratepayers are required to pay a return on only those investments in properties that are used and useful in the public service.
>
> The argument that the security holders should be fully insulated from all risk in this matter is rejected. While a regulated utility may have a lesser degree of risk than unregulated companies that must compete for their markets, this is not to say that it is in the public interest to shield utility security holders from all risks, including the risk that management may initiate projects that do not become productive. This is a risk of any business.
>
> While it is clear that investors in utilities would prefer to have ratepayers absorb losses resulting from aborted projects, such preference does not constitute justification for casting the entire burden of such losses upon ratepayers.
>
> NEP's proposal to afford rate base treatment for the unrecovered portion of this expenditure is rejected.

NEPCO, 8 *FERC* (CCH) ¶ 61,054, at 61,175–76. Nothing in the *NEPCO* decision indicates that the Commission would act differently in a factually different case.

Similarly, this court's decision in *NEPCO* gave Jersey Central no reason to question the veracity of the Commission's *NEPCO* decision as establishing a substantive rule of ratemaking. The only question before us was "whether FERC's refusal to include project expenditures in the rate base, while allowing their recovery as costs over time, is a valid approach to allocating the risks of project cancellation." 668 F.2d at 1333. NEPCO complained that "[t]he sole ground for [the Commission's *NEPCO*] decision was that the expenditures for those facilities did not result in the operation of any used and useful plant." NEPCO Brief at 7. The Commission in turn defended its ruling in a justification of the used and useful rule. FERC Brief in *NEPCO* at 13–20. We held that FERC's approach was valid, without reference to the specific facts of the case, based solely on the Commission's consistent application of the used and useful doctrine. 668 F.2d at 1333–35. In rejecting NEPCO's *Hope* and takings arguments and upholding the Commission's treatment, we held that current ratepayers should bear only the legitimate costs of providing service to them; items not "used and useful" could not be included in the utility's rate base. *Id.* at 1333. Nothing in our opinion could lead Jersey Central to believe we would have found differently had its factual situation been before us.

Significantly, at one time Jersey Central conceded this very point. In appealing the decision of the New Jersey Board of Public Utilities (BPU) to disallow recovery of the carrying charges on the Forked River investment, Jersey Central acknowledged that the BPU decision was consistent with this court's decision in *NEPCO*. Excerpts from Brief on Behalf of Appellant Jersey Central Power and Light Company, before the Superior Court of New Jersey, Appellate Division, J.A. at 22 [hereinafter Excerpts from Jersey Central Brief]. In that proceeding, Jersey Central expended its energies in attacking the reasoning of our decision and in attempting to convince the court that it should encourage the BPU to

employ the "prudent investment" rate base formulation. Jersey Central was motivated by its belief that, unlike the used and useful formulation, the prudent investment approach would afford it the recovery it sought. *Id.*, J.A. at 22–26. Unsuccessful in its undertaking before the state court, Jersey Central apparently rethought the application of our *NEPCO* decision to its case. Its reconstruction does not hold up.

B. The Commission's Generalization of the *NEPCO* Rule

As the majority admits, at least four subsequent decisions laid down the same rule before Jersey Central filed its rates. Maj.Op. at 1184. In NEPCO's second attempt "to include in rate base the unamortized investment in abandoned generating projects," the Commission admonished that it had previously "clearly stated" that such inclusions were "improper." *New England Power Co.*, 16 FERC (CCH) ¶ 61,249, at 61,538 (Sept. 29, 1981) (citing *NEPCO* and summarily disposing of nonconforming portion of filing). In *Northern States Power Co.*, 17 FERC (CCH) ¶ 61,196 (Dec. 3, 1981), *aff'd sub nom. South Dakota Public Utilities Commission v. Federal Energy Regulatory Commission*, 690 F.2d 674 (8th Cir.1982), the Commission again held that the utility could not obtain a return on its lost investment. The case left no room for ambiguity; Jersey Central itself conceded that in *Northern States*, "FERC made clear that its intention was that the investors receive back their entire investment but be denied all return on that investment during the amortization period." Initial Brief of Jersey Central at 19. The Commission applied the *NEPCO* rule summarily, rejecting tariff filings that sought a return on investments not "used and useful."

In both *Ohio Edison Co.*, 18 FERC (CCH) ¶ 16,010 (Jan. 8, 1982), and *Central Maine Power Co.*, 18 FERC (CCH) ¶ 61,126 (Feb. 12, 1982), the agency cited *NEPCO* as its authority for the summary dispositions. These decisions thus clearly established a general rule of summary denial of non-conforming filings by the time Jersey Central made its initial filing in March 1982. *See Black Hills Power and Light Co.*, 19 FERC (CCH) ¶ 61,302, at 61,592 (June 24, 1982) (referring to rate base treatment of cancelled plants as "contrary to well-established precedent"); *see also Violet v. FERC*, 800 F.2d 280, 281 n. 2 (1st Cir.1986) (referring to NEPCO's 1982 agreement not to request reimbursement of the unamortized portion of its cancelled plant as "consistent with Commission policy") (citing *NEPCO*).

The majority belittles the import of these cases by brushing them off as "routine" and comparing them to Jersey Central's filing, which the majority characterizes as "anything but routine." Maj.Op. at 1184. This supposed distinction misses the mark. The Commission had established firm rate-making procedure—summary disposal of unamortized costs of cancelled plants included in electric utilities' rate base filings. The procedure did not vary with "factual differences," no matter how substantial. As to the critical fact, Jersey Central stood in exactly the same position as each other utility—it wanted rate base treatment of its abandoned investment. Jersey Central had no reason to think it would not receive identical treatment—summary refusal.

C. The Natural Gas Pipeline Cases

In a laborious attempt to show that the Commission had begun to waiver in its policy, or indeed was inviting

a utility to request the treatment that Jersey Central in fact sought, Jersey Central cites several gas pipeline cases. The utility maintains that it reasonably read the cases as suggesting a shift by the Commission away from the *NEPCO* rule. The majority agrees. Despite such distinguished ratification of Jersey Central's misreading of Commission precedents regarding gas pipelines, we find nothing in those cases to indicate any waivering by the Commission in its long-standing policy toward the cancelled construction projects of electric utilities.

Trailblazer Pipeline Company, 18 FERC (CCH) ¶ 61,244 (Mar. 12, 1982), the case upon which Jersey Central relies heavily and the majority relies exclusively, fails to validate Jersey Central's non-conforming rate filing. *Trailblazer* involved not a rate filing, but a preconstruction proceeding brought to obtain Commission certification of the appropriateness of the pipeline's financing. The Commission allowed the pipeline to recover debt service on an abandoned project because it was paid for through project financing, in which the stream of income generated by the project was the primary security for the loan. *See also Ozark Gas Transmission System*, 16 FERC (CCH) ¶ 16,099 (July 28, 1981) (approving recovery of actual debt interest for project paid for by project financing). It conditioned approval of inclusion of debt service in rate base "on applicants' waiver of their right to apply for the recovery of their equity investment in this project should it fail." 18 FERC ¶ 16,244, at 61,503.

The majority declares that *Trailblazer* "presented Jersey Central with some additional grounds for believing that the Commission would take a more flexible approach" in its case because the Commission had signalled its frustration with the disparate treatment given gas and electric companies. Maj.Op. at 1184. Yet the majority fails to substantiate the grounds for this belief. In its many permutations, the majority opinion has been unable to come up with an interpretation of *Trailblazer* that both supports Jersey Central's position and withstands scrutiny.

Trailblazer does not even announce a blanket rule allowing recovery of debt service and a return of, but not on, an investment by a natural gas company. It certainly does not hold that such a rule should or could be extended to electric utilities. More important, even if *Trailblazer* were read to control Jersey Central's filing, the utility would not recover the relief it seeks. In fact, the disparity between treatment of gas and electric cases identified in *Trailblazer* is that treatment of cancelled electric plants was *more* generous than treatment of cancelled gas facilities. The majority admits as much. *Id.* at 1185.

As was pointed out in the panel's first opinion in this case, the rule for gas companies would not permit Jersey Central to recover its equity investment, the debt, the carrying charges on the debt, and the preferred stock costs, all of which it attempted to do by including the Forked River investment in its rate base. Arguing that this understanding of *Trailblazer* is erroneous, the majority maintains that the Commission "suggest[ed]" that conventionally-financed pipelines would not have to waive their right to recover the equity investment in order to recover a return. *Id.* at 1185 n.6. We cannot locate any such suggestion in anything the Commission said. Indeed, any suggestion to be found is quite to the contrary.

In *dicta*, *Trailblazer* discussed the tariff that the Commission would consider if the pipeline opted for conventional rather than project financing. The Commission indicated that it would permit the applicant to "apply for recovery *of* the total investment in the project should it fail." 18 FERC (CCH) ¶ 61,244, at 61,504 (emphasis added). The Commission observed that the policy consideration of encouraging investment in prudent yet possibly risky projects pointed "in the direction of a consistent and more liberal allowance of abandoned plant costs in *cost of service*." *Id.* at 61,502 (referring to amortization of abandoned projects) (emphasis added). This observation, however, had no bearing on the Commission's policy of excluding a current return on an abandoned plant from the *rate base*. There is no suggestion that any utility should in addition receive a return *on* the equity portion of the investment. *See id.* at 61, 503 & n. 17. Indeed, the Commission expressed concern that even allowing a return *of* that investment creates too great an incentive for imprudent investments. *See id.* at 61,503 (stating that FERC's ratemaking procedures should "*not* promote investment in projects undertaken simply because the bill can be passed on to the ratepayers").

The majority misunderstands the ramifications of the Commission's assertion that there "is no obvious reason why the treatment of abandoned plant costs as between gas and electric companies should differ," *id.* at 61,511 n. 15. It was saying that in an appropriate natural gas case, one not paid for by project financing, amortization of abandoned plant costs should be allowed because it was already allowed in the electric company context. *See id.* (citing *NEPCO, supra, and Northern States Power Company supra); of Natural Gas Pipeline Co. v. Federal*

Energy Regulatory Commission, 765 F.2d 1155 (D.C.Cir. 1985) (establishing on its facts that a pipeline was not entitled to amortize its out-of-pocket expenses, to say nothing of its debt or carrying charges, for abandoned projects), *cert. denied*, ____ U.S. ____, 106 S.Ct. 794, 88 L.Ed.2d 771 (1968). Jersey Central has already benefited from this investment-fostering liberal approach. Unlike gas companies, Jersey Central was allowed to recover the expenditure made on its failed construction project.

The majority inexplicably seems to elevate Jersey Central's reliance on *Trailblazer's* supposed indication of the Commission's "flexibility" to a point of independent legal significance. *See* Maj.Op. at 1185 & n. 7. Regardless of the reasonableness of the company's expectation, one must query just how much Jersey Central "relied" upon *Trailblazer* in making its filing. In its initial brief to this court for review, the utility cited *Trailblazer* as additional support for its argument that the Commission should permit full amortization *and* a return on the debt and preferred portions of the unamortized amount. Initial Brief of Jersey Central at 20. However, it characterized the *Trailblazer* opinion as having been issued "shortly *after* Jersey's Central filing," *id.* at 8 (emphasis added), even though, as the majority notes, the opinion was published two weeks before the filing, Maj.Op. at 1185.

Whatever Jersey Central's intent, belief, or expectation, *Trailblazer* cannot carry the utility where it desperately wants to go, and where the majority is all too willing to usher it. *Trailblazer* never questions the continuing validity of the used and useful principle, which it would have to do to raise a reasonable doubt in Jersey Central's mind that the continuing validity of *NEPCO*

was open to question. We therefore conclude that summary disposition of Jersey Central's initial rate filing was appropriate under settled *NEPCO* used and useful doctrine. *See* 18 C.F.R. § 385.217 (1986) (summary disposition procedure). At the time Jersey Central filed its proposed rate revision, the requirement that the rate base exclude certain unallowable items had been upheld by this court; the Commission had stated its practice of applying this requirement; and the agency had not deviated from this position. Under these circumstances, the Commission properly rejected the non-conforming portion of Jersey Central's filing pursuant to its standard policy.

Petitioner stated at oral argument that in its proceeding before the Commission it set out to test the *NEPCO* doctrine. Everyone can appreciate Jersey Central's frustration with what it believed to be an unwise and ill-conceived rule. But the proper forum for challenging an agency rule is in a regulatory rulemaking proceeding, *not* in a ratemaking proceeding. *See generally* 1 K. Davis, *Administrative Law Treatise*, § 6:1 *et seq.* (1978). FERC is now, pursuant to a Notice of Inquiry, re-evaluating its entire approach to the regulation of wholesale electric requirements service. The agency intends to focus, in particular, on "the pricing and risk allocation policies," including its cancelled plant policy. *See* 31 FERC (CCH) ¶ 61,376 (June 28, 1985); *Regulation of Electricity Sales-for-Resale and Transmission Service*, 50 Fed.Reg. 27,604, at 67,612–14. (July 5, 1985). That is where Jersey Central should make its stand. The utility should not be allowed to convert a rate case into an involuntary rulemaking and manipulate this court into approving procedures FERC has rejected.

The majority puts this Notice of Inquiry to preposterous use. Although it buries its point in a footnote, the majority makes the remarkable assertion that the fact that the Commission has initiated this rulemaking proceeding "indicate[s]" that the agency had no "genuine rule with respect to the treatment of cancelled plants." Maj.Op. at 1185 n. 7. The fact that the Commission's regulatory policy with regard to electric utilities is evolving lends absolutely no support to the majority's and Jersey Central's contention that the agency had not established a firm rule in *NEPCO* and its progeny. An agency has every right, and indeed the responsibility, to reconsider and restructure its rules and policies when the circumstances warrant change. Regulatory policies are always in "a state of flux." *See id.* This evolution does not render the rules promulgated any less authoritative. Indeed, Congress has chosen to regulate through agencies in order to avoid the cumbersome, legislative process and to take advantage of agencies' ability to respond to everchanging industry practices and economic environments.

The Notice of Inquiry issued by the Commission cannot excuse the majority's willingness to second-guess the agency's policies. Courts have no place substituting themselves for agencies. Had Congress intended the courts to act as the supreme regulatory bodies, they would have made us subject to strictures, beyond Article III, that would preclude the freewheeling approach taken by the majority in its opinion today.

D. The Inappropriateness of Using Rate Base Calculation to Address Utilities' Financial Concerns

The infirmity of the majority's decision extends beyond its disregard for *NEPCO* as a rule of policy

regarding rate base calculation. Ratemaking is a complex process involving consideration of a myriad of factors. *See generally Regulation of Electricity Sales-for-Resale and Transmission Service*, 50 Fed.Reg. 27,604 (July 5, 1985) (discussing pricing and risk allocation policies toward electric utility requirements service). The more systematic the practice, the easier and more efficient the process can be for both the Commission and the individual utility. *See, e.g.*, 18 C.F.R. §§ 35 and 290 *et seq.* (1986) (outlining rules and procedures for filing of rate schedules and collection of cost of service information). If the majority's rationale is followed, items such as cancelled nuclear power plants will be included or excluded from utility rate bases dependent on the financial condition of the utility. Ad hoc rules for rate base composition invite a chaotic state of the law in a regulatory arena where certainty and predictability help ensure that just and reasonable rates are established.

Furthermore, rate base calculation is much too clumsy a tool for adjusting total return to accommodate the state of the utility's finances. Generally, the rate base is comprised of total capital invested in facilities minus depreciation plus cash working capital. The rate of return, on the other hand, is a weighted average of different rates applied to debt, preferred stock and common stock. Thus, the rate of return is the normal and most suitable vehicle for taking account of a given utility's fluctuating financial needs. Not surprisingly, as the Commission explained at oral argument, it is here that FERC does most of its "tinkering." *See* Maj.Op. at 1186–87. Indeed, it was through adjusting rate of return that FERC and Jersey Central settled their differences in this rate filing.

In addition, the majority's approach creates disincentives for a utility to operate efficiently. As the Commission observed, "[a] firm is more likely to work to minimize its costs if its financial health is at stake. . . . Thus, firms that bear significant business risk are more likely to produce efficiently than those [who] are sheltered from this risk." 50 Fed.Reg. at 27,612. Yet, under the majority's rationale not only are producers able to shift the risk of loss onto their ratepayers, but they are more likely to be able to do so if the loss is great and they are otherwise under financial strain. A healthy utility does not get its prudently incurred but cancelled expenditure included in its rate base, but a sickly utility does.

The Commission has expressed its concern that allowing recovery of the expenditure through amortization may reduce incentives for utilities to "avoid embarking upon questionable construction projects, or to stop work on partially constructed ones after their economic value has become unclear," or "to minimize construction costs." 50 Fed.Reg. at 27,614. If the company is more likely to recover not only its out-of-pocket costs but also a return on those costs if it is in financial decline, then the incentives for efficient production are reduced even further. And, as the concurrence points out, we are not dealing with small change. *See* Sep.Op. at 1188. The disincentives are large ones. Thus, the majority's method of treating rate base calculation frustrates the Commission's goal of "achiev[ing] the most efficient allocation of resources possible." *See Northern Natural Gas Co. v. FPC*, 399 F.2d 953, 959 (D.C.Cir. 1968).

The majority asserts that it is not insisting that Jersey Central receive the financial relief it seeks through a

rate base adjustment. *See* Maj.Op. at 1182 n. 5. The majority protests too much. Rate base treatment of Jersey Central's cancelled plant is, of course, the very thing at issue. The utility, as stated in its filing and as credited by the majority, has presented the rate package that it alleges will provide the minimum amount necessary to avoid nonconfiscatory rates; each element of the proposed rate structure is essential. Indeed, the majority argues, in response to our point that Jersey Central had other forms of relief open to it (other than inclusion of its cancelled plant in the rate base), that other alternatives would not meet the utility's specific financial needs. *See* Maj.Op. at 1186–87. The majority cannot have it both ways, and its refusal to accept the ramifications of its opinion in this regard reveals the extent to which it is blind to Jersey Central's real motivation—nullification of the *NEPCO* doctrine.

III. The Utility's Right to an Evidentiary Hearing

There may be times when the Commission cannot issue an interim summary disposition order even when based on a long-established settled rule. Jersey Central argues that this is such a time. It claims that the substantive policies and procedural filing requirements that the Commission established for recovery of abandoned power projects, whatever their merit for utilities facing less dire financial straits, were invalid as applied to Jersey Central's particular rate filing. The utility contends that the Commission's rate base requirements so jeopardized Jersey Central's financial integrity and long-term ability to attract capital that the Commission's order threatened to confiscate the capital that its owners had invested, in contravention of the *Hope* end

result test. Accordingly, it asserts that the Commission cannot summarily apply its *NEPCO* rule; rather, it must hold an evidentiary hearing concerning proper treatment of the utility's proposed rate base items. While acknowledging the electric utility industry's need to attract investors, we find that Jersey Central presents no valid reason why these concerns justify exemption from the Commission's clear requirements. The majority obviously disagrees. It is here that the majority opinion may cause the most confusion and caprice.

Ratemaking calls for "pragmatic adjustments" clearly within the province of the Commission, which "must be free . . . to devise methods of regulation capable of equitably reconciling diverse and conflicting interests." *Mobil Oil Corp. v. FPC*, 417 U.S. 283, 331, 94 S.Ct. 2328, 2356, 41 L.Ed.2d 72 (1974) (quoting *Permian Basin Area Rate Cases*, 390 U.S. 747, 767, 88 S.Ct. 1344, 1360, 20 L.Ed.2d 312 (1968)). The broad discretion the Commission enjoys in its ratemaking determinations, however, must be bridled in accordance with the statutory mandate that the resulting rates be "just and reasonable." In *Hope*, the Supreme Court articulated the standard by which a reviewing court examines a challenged rate. "Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling. . . . If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end." 320 U.S. at 602, 64 S.Ct. at 288 (citations omitted). Thus, *Hope* is a limit on judicial scrutiny, not a probing device for courts restless to enter the fray between utilities and the Commission on the actual rates to be approved.

Remarkably, the majority invokes *Hope* to direct the methods the Commission may employ in fashioning

Jersey Central's rates. Our colleagues accept Jersey Central's contention that "the Commission may not *summarily* exclude an investment from the rate base when the utility has alleged that its ability to attract capital will be seriously jeopardized as a result." Maj.Op. at 1172. They therefore conclude that the company is entitled to a hearing in order to have the opportunity to prove its allegations and demonstrate that the end result of the Commission's order—were it carried out—would violate the *Hope* standards. Regardless of the propriety of the Commission's used and useful policy, the majority holds that, given Jersey Central's allegations regarding its financial status, a hearing is required in order to implement this policy. To the contrary, we find nothing in Jersey Central's initial filing and its application for rehearing that demonstrates a need for a hearing at this stage of the proceeding.

Section 205 of the Federal Power Act, 16 U.S.C. § 824d(e) (1982), provides that "the Commission shall have authority . . . to enter upon a hearing" on the legality of a rate increase. This provision authorizes, but does not require, the Commission to conduct full-scale evidentiary hearings; the Commission may dispose of issues summarily if there is no need for a hearing. *See Cities of Batavia v. Federal Energy Regulatory Commission*, 672 F.2d 64, 91 (D.C. Cir.1982). In particular, a utility is not entitled to a hearing before the non-conforming portion of its rate filing is rejected, *see Southern California Edison Co. v. Federal Energy Regulatory Commission*, 686 F.2d 43, 47 (D.C.Cir.1982), or when it challanges an established policy. *See Papago Tribal Utility Authority v. Federal Energy Regulatory Commission*, 628 F.2d 235, 242 (D.C.Cir.), *cert. denied*, 449 U.S. 1061, 101 S.Ct. 784, 66 L.Ed.2d 604 (1980); *Municipal Light Boards v.*

FPC, 450 F.2d 1341, 1345–46 (D.C.Cir.1971); *see also* 3K. Davis, *Administrative Law Treatise* § 14.5 at 26–27 (1980) ("When a utility's entire filing consists of a legal challenge to well-entrenched policy, there is no need for the Commission to grant the challenger a hearing."). The Commission is under an obligation to grant a hearing only if the utility raises an "issue of adjudicative fact." *See United States v. Storer Broadcasting Co.*, 351 U.S. 192, 205, 76 S.Ct. 763, 771, 100 L.Ed. 1081 (1956); *Citizens for Allegan County, Inc. v. FPC*, 414 F.2d 1125 (D.C.Cir.1969).

Had Jersey Central raised a "serious *Hope* challenge," as the majority believes it did, Maj.Op. at 1178, there would be an issue of adjudicative fact which necessitates a hearing rather than summary disposition. The issue would be whether any action taken by the Commission to reduce the rates permitted Jersey Central would produce an unjust and unreasonable end result; that is, whether Jersey Central had proposed the "minimum" non-confiscatory rates possible. In summarily excluding the non-conforming costs from the rate base, the Commission impliedly determined that the utility had raised no issue of fact. Based on Jersey Central's allegations and the evidence before the Commission, we find this conclusion reasonable.

A. The Showing Necessary to Obtain a *Hope* Hearing

In order for Jersey Central to raise a serious *Hope* challenge, its allegations, if true, must suggest that the Commission's interim order—the exclusion of unamortized abandoned plant costs from the rate base—would result in unjust and unreasonable rates. According to the majority, Jersey Central has made the showing necessary to obtain a *Hope* hearing. Maj.Op. at 1169.

The majority is convinced by the utility's allegation that "the company has been shut off from long-term capital, is wholly dependent for short-term capital on a revolving credit arrangement that can be cancelled at any time, and has been unable to pay dividends for four years." *Id.* at 1181. This proffer simply echoes the investor interest described in *Hope*. See 320 U.S. at 603, 64 S.Ct. at 288, Maj.Op. at 1171–72. A utility must do more than recite the frustration of its stockholders' interests in order to obtain a *Hope* hearing. Thus, we cannot agree with the majority that "[t]he allegations made by Jersey Central and the testimony it offered track the standards of *Hope* and *Permian Basin* exactly." *See* Maj.Op. at 1178.

We need not adopt what the majority relentlessly maintains is FERC's interpretation of the required showing—"the order would put the utility into bankruptcy"—in order to reject the showing presented by Jersey Central. *See id.* at 1175, 1177, 1179, 1180. Nor need we decide what precise allegations and evidence would ultimately comprise the necessary showing. The court need only find, as we do, that Jersey Central's showing does not suffice. There are at least three types of showings which, in our view, are crucial to any attempt to obtain a *Hope* hearing at this intermediate stage of the rate proceeding and which are largely overlooked in the majority's opinion and absent from Jersey Central's filing.

1. The Nexus Between the Rate Order and the Utility's Financial Plight

It is axiomatic that FERC is not a guarantor of Jersey Central's financial health and that a utility may even go bankrupt for reasons beyond the regulator's

control. *See, e.g., Hope*, 320 U.S. at 603, 64 S.Ct. at 288. The Act and its constitutional limits ensure that the governmental ratemaking process does not "produce arbitrary or unreasonable consequences." *Permian Basin*, 390 U.S. at 800, 88 S.Ct. at 1377. They do not protect the utility from market forces. *Market Street Railway Co. v. Railroad Commission of California*, 324 U.S. 548, 567, 65 S.Ct. 770, 779, 89 L.Ed. 1171 (1945). Establishing a link between a utility's bad health and the actions of the regulator is thus essential to raising a viable *Hope* claim.

Jersey Central has not established this critical nexus. It simply complains that the government's ratemaking actions are the source of its problems; our colleagues never question this assumed causal connection. An examination of the evidence laid before FERC, however, leads us to doubt the validity of this assumption.

In its present financial circumstances, Jersey Central bears greater resemblance to the failing Market Street Railway Company than it does to the Hope Natural Gas Company, "which had advantage of an economic position which promised to yield what was held to be an excessive return on its investment and on its securities." *Market Street*, 324 U.S. at 566, 65 S.Ct. at 779 (finding investor considerations advanced in *Hope* "inapplicable to a company whose financial integrity already is hopelessly undermined"). Jersey Central had not been able to pay dividends for the four years prior to its filing; its access to capital had been hampered for about as long. Essentially, the utility is asking the Commission to relieve its economic miseries by approving dramatically increased rates. *See* Testimony of Dennis Baldassari, J.A. at 34 (testifying that the continuation of the present rate "will prolong the Company's inability to restore itself to a recognized level of credit worthi-

ness"); *compare Permian Basin*, 390 U.S. at 812, 88 S.Ct. at 1384 (noting that the rates proposed would "*maintain* the industry's credit and *continue* to attract capital") (emphasis added). Jersey Central's problems appear to stem largely from the operations of the free market, perhaps exacerbated by the actions of other regulators. FERC cannot be made responsible for curing those ills.

The Supreme Court has enunciated this principle quite frankly:

> The due process clause has been applied to prevent governmental destruction of existing economic values. It has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces.

Market Street, 324 U.S. at 567, 65 S.Ct. at 780.

The entire electric utility industry faces a "financial crisis." *See* Excerpts from Jersey Central Brief, J.A. at 26 n. 19. As Baldassari remarked, the October 1973 oil embargo and the impact of inflation are problems generic to the industry. Testimony of Dennis Baldassari, J.A. at 33. Those utilities that invested heavily in nuclear facilities were particulary hard hit, not in the least by adverse public and political attitudes to nuclear power and its attendant dangers. *See id.* at 33–34. Any fair reading of Baldassari's testimony before FERC leads to the conclusion that economic forces, rather than any action on the part of FERC, have strapped Jersey Central into the financial straightjacket.

It should be noted that Jersey Central's investment portfolio places it in a uniquely tight predicament. Jersey Central is a subsidiary of the General Public Utilities Corporation, the electric utility that has among its

"prudent" investments the Metropolitan Edison Company and the infamous Three Mile Island (TMI) nuclear generating plant. Jersey Central intimates that the horrendous financial burden caused by the TMI-2 accident was the pivotal force in suspending construction of Forked River. *See id.* Presumably it also landed a heavy blow to Jersey Central's credit worthiness and financial integrity.

The market is not the only force potentially at work against Jersey Central. Many regulatory bodies have influence over Jersey Central's economic destiny; therefore, the utility must effectively link its financial distress to FERC. This showing is particularly important, since the federal government is responsible—on the whole—for the value of only about ten percent of electricity sales in the United States. The states regulate the major part of the utility business. As noted earlier, the New Jersey BPU has historically refused Jersey Central a return on unproductive facilities. *See* Excerpts from Jersey Central Brief, J.A. at 17 (blaming the company's financial woes on BPU's lack of rate relief). In addition, there are other federal agencies who share regulatory control with FERC. The Nuclear Regulatory Commission, for example, prohibited the company from starting up the unharmed TMI-1 generator, thereby severing the company's access to its prime source of desperately needed service and revenues.

If Jersey Central's problems derive from economic forces or from the actions of other regulatory bodies, then even FERC's full rate base treatment of the amounts at issue will not alter the company's inability to pay dividends or obtain long-term credit. At a minimum, a company claiming an unconstitutional taking

should have to show that FERC's actions caused or substantially contributed to the conditions alleged to be the result of the taking. Jersey Central has made no such showing. In fact, it appears as if the Commission's interim rate-reducing order is a small factor in the forces contributing to the utility's financial dilemma.

The majority takes the remarkable position that the Commission must alter its ratemaking procedures even if the utillity can only show that the Commission's action only affects "a minor portion of Jersey Central's business." Maj.Op. at 1182 n. 5. Such a position is untenable. From this perspective, the agency would be obliged to abandon its ratemaking procedures in every industry which experienced financial hardship, regardless of the principal causes of those conditions. Neither *Hope* nor the due process clause requires as much. *See Market Street*, 324 U.S. at 567, 65 S.Ct. at 779.

2. The Effects on Consumers

The burden is ultimately on Jersey Central to establish that the return allowed by FERC is constitutionally inadequate; part of the showing necessary to raise an issue of fact must include attention to the consumer interests which form an important part of the *Hope* balancing test. Under *Hope*, a taking occurs only when the agency has misbalanced the interests of investors and consumers. As the Court stated in *Permian Basin*,

> [t]he Commission cannot confine its inquiries [to the *Hope* investor criteria]; it is instead obliged at each step of its regulatory process to assess the requirements of the broad public interests entrusted to its protection by Congress. Accordingly, the "end result" of the Commission's orders must be measured as much by the success with which they

> protect those interests as by the effectiveness with which they "maintain . . . credit and . . . attract capital."

390 U.S. at 791, 88 S.Ct. at 1372.

The consumer interest essential to the just and reasonable balance is that of not being subjected to exploitative rates. The Commission stands as the watchdog providing "a complete, permanent and effective bond of protection from excessive rates and charges." *Id.* at 795, 88 S.Ct. at 1374 (quoting *Atlantic Refining Co. v. Public Service Commission*, 360 U.S. 378, 388, 79 S.Ct. 1246, 1253, 3 L.Ed.2d 1312 (1959)). Thus, this court has described utility consumers as the agency's "prime constituency." *See Maryland People's Counsel v. FERC*, 761 F.2d 780, 781 (D.C.Cir.1985) (citing *Hope*, 320 U.S. at 620, 64 S.Ct. at 296). The exact boundaries of an exorbitant rate are indeterminate. Ultimately, however, they must relate to the cost of service, *see Farmers Union Central Exchange, Inc. v. FERC*, 734 F.2d 1486, 1502 (D.C.Cir.) (citing *Hope*, 320 U.S. at 602–03, 64 S.Ct. at 287–88), *cert. denied sub nom., Williams Pipe Line Co. v. Farmers Union Central Exchange, Inc.*, 469 U.S. 1034, 105 S.Ct. 507, 83 L.Ed.2d 298 (1984), and the distribution of associated risk, *see Washington Gas Light Co. v. Baker*, 188 F.2d 11, 20 (D.C.Cir.1950).

Jersey Central argues that the agency has discriminated against its investors' interests, but it does not address how the Commission's balance weighed the consumer interests. More significantly, it does not show that paying more attention to its investors' interests would not exploit the consumer. *See* 18 C.F.R. § 35.13(e)(3)(1986)(stating that the utility has the burden of "establishing that the rate increase is just and

reasonable and not unduly discriminatory or preferential").

The majority is in seeming confusion as to the showing the company made with regard to protection of consumer interests. It states, without support, that "Jersey Central submitted figures and testimony to support its claim that . . . its proposed rates would not exploit consumers." Maj.Op. at 1180. Yet, in fact, Jersey Central itself never made this "claim"; it never broached the issue. The majority resurrects an unpersuasive argument in support of its contention—namely, that "the rates proposed in its filing would remain lower than those of neighboring utilities." *Id.* at 1181; *see Jersey Central Power & Light Co. v. FERC*, 768 F.2d 1500, 1502 (D.C. Cir.1985). Perhaps this point would lend support to the majority's assertion were there a competitive market for electricity service. But of course there is no competition in this market; electric utilities are natural monopolies subject to rate regulation. "What rates are 'just and reasonable' will in general depend on a utility's legitimate costs, and those costs can of course vary widely even among neighboring utilities. . . . That some utilities with monopoly markets adjacent to Jersey Central's are allowed to charge more than Jersey Central thus presumably signifies nothing more than that Jersey Central has access to cheaper sources of power, or for some other reasons has fewer legitimate costs." 768 F.2d at 1512 (Mikva, J., dissenting). It certainly does not show that Jersey Central's proposed rates would not exploit *its* customers.

The majority admits that "it is impossible for us to say at this juncture whether including the unamortized portion of Forked River in the rate base would exploit consumers *in this case*." Maj.Op at 1181. Since Jersey

Central alleges that its proposed rate schedule would yield the lowest nonconfiscatory rate possible, how can the majority then say that the company has made a *Hope* showing? Without a showing that its filing would *not* exploit consumers, Jersey Central has not presented allegations suggesting that the rate order does not meet the requirements of *Hope*. *Contra id.* at 1181. Absent such allegations, the utility is not entitled to a *Hope* hearing.

3. The Reasonableness of the Overall Return Allowed on the Forked River Project

Regardless of the formulation employed, the rates fixed by the Commission may not shift the risk of loss onto the consumer and then exact the practice of the loss from him in the event it occurs. Such a double taxing "would clearly violate the consumer interest against 'exorbitant' rates." *Washington Gas Light*, 188 F.2d at 20. Before questioning the application of the used and useful rule, therefore, it is important to discover if the investors in Forked River have already been compensated for the risk that the project would be cancelled before the investment in it was entirely recovered. *See id.* at 19–20.

The total return received by a utility is a function of both the rate base and the rate of return, and the total return on any given investment is a function of the allowable return over a period of time. Jersey Central has focused only on the "used and useful" method of rate base calculation with no attention to the rate of return, especially to the manner in which that return may arguably have already compensated its investors for the exclusion of the cancelled investment from the rate base. Without an explanation of the company's historic

allowed return, it is impossible to judge the reasonableness of the Commission's treatment of the Forked River plant.

In *Washington Gas Light*, the case so heavily relied upon by the majority, this court upheld a departure from the "used and useful" method of rate base calculation to the "prudent investment" approach. However, before approving the application of that formulation to the abandoned plant in that case, we remanded for further proceedings by the Commission. Contrary to the majority's explanation, we did not require findings concerning the "financial health" of the company. *See* Maj.Op. at 1177. A remand was necessary because Judge Bazelon realized that it was possible that the investors had already been compensated for the risk that the plant at issue would be abandoned. As Judge Bazelon observed, "[i]t seems likely . . . , in view of the prevalence in the past of the doctrine that abandoned property would not be included in the rate base (regardless of whether [rate orders] had resulted in complete recovery to the investor), that investors had been compensated for the risk of obsolescence." 188 F.2d at 20. Thus, it was possible that the rate of return allowed the company in earlier years—if properly calculated to reflect the risks of the utility business—would have compensated the company in advance for the risk that it would not obtain full rate base treatment of its investment later on. If the rate of return had served that risk compensation function, allowing additional recovery by switching rate base formulations midstream would overcompensate the utility and exploit the consumers. *Id.* at 19–20.

Jersey Central has made no allegations regarding the prior treatment of the Forked River plant in its ap-

proved rate of return. *Compare* Testimony of Dennis Baldassari, J.A. at 35 ("[T]he rates of return allowed in previous regulatory proceedings were never intended to compensate the investor for the risk of exposure to the costs of decontaminating TMI-2."). If Jersey Central has been compensated for the plant all along because its rate of return has historically been set in a world where one of the risks of being a utility is having an investment declared not to be "used and useful," then FERC has probably fulfilled its obligations under *Hope*.

In sum, in order to obtain a *Hope* hearing, Jersey Central must show that, due to the Commission's actions, it is in need of protection at this phase of the ratemaking process. That showing is conspicuously missing. Without it, the court has no business calling upon the Commission to alter its ratemaking procedures and provide a hearing at this interim stage. Once again, a protective device—the *Hope* end result test—is being used as a first strike weapon.

B. Limits of a "Just and Reasonable" Rate

In that Jersey Central is not entitled to a *Hope* hearing, it would normally be thought unnecessary to consider what the utility would have to prove, were it granted a hearing, in order to establish that the Commission's rates are confiscatory. The concurrence's attempt to analyze the evidence presented, while thoughtful, is premature. Because of breadth of the majority's opinion today, however, we are compelled to discuss the issue.

The real mischief of today's decision lies not in the majority's belief that the utility has raised an issue of fact necessitating a hearing, but in its determination that Jersey Central has actually made out a case of

constitutional confiscation. As Justice Douglas remarked, "he who would upset the rate order under the Act carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences." *Hope*, 320 U.S. at 602, 64 S.Ct. at 288. The majority believes that Jersey Central can meet this burden. We simply cannot swallow the majority's assertion that "it is probable that the facts alleged [by Jersey Central], if true, would establish an invasion of the company's rights." *See* Maj.Op. at 1169. In our view, it is beyond cavil that Jersey Central has not presented allegations which, if true, would establish that the Commission's orders result in unjust and unreasonable rates.

Despite the majority's seeming confidence, the precise contours of this required showing are unclear. The just and reasonable statutory standard is imprecise. As this court once explained, "the words themselves have no intrinsic meaning applicable alike to all situations." *City of Chicago v. FPC*, 458 F.2d 731, 750 (D.C.Cir.1971) (quoting *City of Detroit v. FPC*, 230 F.2d 810, 815 (D.C. Cir.1955)), *cert. denied*, 405 U.S. 1074, 92 S.Ct. 1495, 31 L.Ed.2d 808 (1972). Congress itself has provided no formula for determining an unjust and unreasonable rate. *Hope*, 320 U.S. at 600, 64 S.Ct. at 286. Cases subsequent to *Hope* have loosely defined this "deliberately broad" standard as drawing a "zone of reasonableness in which rates may properly fall. It is bounded at one end by the investor interest against confiscation and at the other by the consumer interest against exorbitant rates." *See, e.g., Washington Gas Light*, 188 F.2d at 15. Thus, the only way that a rate may fall outside the zone of reasonableness, from the utility's point of view, is if it is so low that it amounts to a unconstitutional taking under

the fifth amendment. *See FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586, 62 S.Ct. 736, 743, 86 L.Ed. 1037 (1942).

Ascertaining what constitutes a taking in the rate regulatory context is difficult, in part because there is no deprivation of typical property interests, the conceptual cornerstone of takings law. The Supreme Court has repeatedly stressed that price fixing does not effect an uncompensated taking merely because investors are denied their expected return. Indeed, even in traditionally competitive industries, "loss of future profits—unaccompanied by any physical property restrictions—provides a slender reed upon which to rest a takings claim." *Andrus v. Allard*, 444 U.S. 51, 66, 100 S.Ct. 318, 327, 62 L.Ed.2d 210 (1979).

In *Permian Basin*, the Court restated the *Hope* doctrine as follows:

> Price control is "unconstitutional . . . if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt. . . ." Nonetheless, the just and reasonable standard of the Natural Gas Act "coincides" with the applicable constitutional standards, and any rate selected by the Commission from the broad zone of reasonableness cannot be attacked as confiscatory.
>
> Accordingly, there can be no constitutional objection if the Commission, in its calculation of rates, takes fully into account the various interests which Congress has required it to reconcile.

390 U.S. at 769-70, 88 S.Ct. at 1361 (citations omitted).

Permian Basin teaches that if the Commission reasonably balances consumer and investor interests, then the resulting rate is *not* confiscatory. *Id.* at 770, 88 S.Ct. 1361. The separate opinion ably translates this into a

working definition of a confiscatory rate: it exists when "an unreasonable balance has been struck in the regulation process so as unreasonably to favor ratepayer interests at the substantial expense of investor interests." Sep.Op. at 1189. The majority appears to agree with the teaching of *Permian Basin*. *See* Maj.Op. at 1177–78. The lesson it gleans, however, is incongruous. According to the majority, balancing competing interests is not enough; a rate is confiscatory if it does not *satisfy* the "legitimate investor interest" outlined by the Court in *Hope*. Maj.Op. at 1177–78, 1180, 1181 n. 3, 1181–82 (insisting that the factors outlined in *Hope* describe a taking). This interpretation of *Hope* and *Permian Basin* is implausible.

The majority's assessment of Jersey Central's showing evinces a fundamental misunderstanding of the context in which the *Hope* Court discussed investor interests. It specified the interests at issue but did not require that rates fulfill them in order to be non-confiscatory. In *Hope*, the Court faced an assertion by the utility that the rates fixed by the Commission were so low as to be unjust and unreasonable. In testing this challenge, the Court essentially questioned whether the utility's shareholders had anything to complain about. The Court examined what was "important" "from the investor or company point of view" and found that the rate at issue fully satisfied any legitimate investor interest. 320 U.S. at 603, 64 S.Ct. at 288. Accordingly, the Court held that the rate could not be condemned from the investor viewpoint. *Id.* at 64 S.Ct. at 288, 289. One year later, Justice Jackson, speaking for a unanimous Court, refuted the majority's interpretation of the Court's holding in *Hope*: "All that was held was that a company could not complain if the return which was allowed made it

possible for the company to operate successfully." *Market Street*, 324 U.S. at 566, 65 S.Ct. at 779. The *Hope* Court did not define "unjust or unreasonable"; nor did it articulate when a rate would be confiscatory. It certainly did not hold that the end result could be condemned if the investor criteria defined in the case were not fulfilled. Indeed, it expressly noted that its holding made no suggestion that more or less might not be allowed. 320 U.S. at 603, 64 S.Ct. at 288; *see Market Street*, 324 U.S. at 566, 65 S.Ct. at 779.

This understanding of *Hope* is the only way to reconcile the Court's recitation of investor interests with its avowal that "regulation does not insure that the business shall produce net revenues." *See Hope*, 320 U.S. at 603, 64 S.Ct. at 288 (quoting *Natural Gas Pipeline*, 315 U.S. at 590, 62 S.Ct. at 745). Investor interests are only one factor in the assessment of constitutionally reasonable, therefore non-confiscatory, rates. *Permian Basin*, 390 U.S. at 769, 88 S.Ct. at 1361. In any instance, the rate must also "provide appropriate protection to the relevant public interests, both existing and foreseeable." *Id.* at 792, 88 S.Ct. at 1373. A just and reasonable rate which results from balancing these conflicting interests might not provide "enough revenue not only for operating expenses but also for the capital costs of the business . . . includ[ing] service on the debt and dividends on the stock." *See Hope*, 320 U.S. at 603, 64 S.Ct. at 288.

The Court made this abundantly clear in *Market Street*. The Commission rate order in *Market Street* was claimed to be confiscatory. 324 U.S. at 562, 65 S.Ct. at 777. Like Jersey Central, the complaining company asserted that *Hope* "entitled [it] to a return 'sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital'

and to 'enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed.' " *Id.* at 566, 65 S.Ct. at 779 (quoting *Hope*, 320 U.S. at 603, 605, 64 S.Ct. at 288, 289). The Court dismissed the argument out of hand. In approving a rate that concededly consigned the company to operating at a loss, the Court made clear that a just and reasonable rate might not satisfy the investor "considerations" expounded in *Hope*. At the very least, the Court revealed that the *Hope* test does not guarantee rates that are fixed to provide a return "on an investment after it has vanished, even if once prudently made, or to maintain the credit of a concern whose securities already are impaired." *Id.* at 567, 65 S.Ct. at 780.

Neither the regulatory process nor the fifth amendment shelter a utility from market forces. *See id.* Thus, contrary to the majority's intimations, rates do not fall outside the zone of reasonableness merely because they do not enable the company to operate at a profit or do not permit investors to recover all their losses.

The zone of reasonableness can be viewed as circumscribing the appropriate allocation of costs and benefits in the regulatory context. In an unregulated environment, the customer would not be deemed a risk-taker. He invests no capital in the enterprise and therefore bears neither the upside nor the downside risk. The investors are the risk-takers. Under price regulations, which affords the utility a "natural monopoly" on service, some of the risk at either end of the spectrum is shifted onto the ratepayer. The transfer, however, is not so dramatic as to relieve the stockholder of the entire risk of loss.

Application of this principle is readily apparent in the Commission's current treatment of electric utility plants, investments prudent when made but sometimes frustrated in fruition. If the investment is successful, the customer benefits from controlled rates for the service provided. But the ratepayer also shares the costs if the investment fails; he must pay for the expenditure made on an unproductive facility from which he obtains no service. From the investor's viewpoint, price regulation cabins both his upside and downside risk. He cannot collect the windfall benefits if the project is a boon; he does not bear all costs if the project is a bust. Electric utility stockholders do not lose equity in the nonserviceable facility, as they might in the marketplace. They simply do not procure a return on the investment.

The majority quibbles with this risk allocation; it would prefer a world in which the investor is guaranteed a return on his investment, if prudent when made. *See* Maj.Op. at 1180–81 & n. 2. Its resultant holding today is directly at odds with fundamental principles laid out in *Hope* and its progeny. Adherence to the majority's insistance on the inclusion of prudent investments in the rate base would virtually insulate investors in public utilities from the risks involved in free market business. *See* Sep.Op. at 1190. This would drastically diminish protection of the public interest by thrusting the entire risk of a failed investment onto the ratepayers. *See id.* at 1190. Jersey Central and the majority would convert utility stockholders from risk-takers into annuity holders. *See* Excerpts from Jersey Central Brief, J.A. at 18 (analogizing its suggested "cost-sharing" to a levelized mortgage or annuity). Neither *Hope* nor the fifth amendment takings clause sanctions such radical results. *Cf. Hope*, 320 U.S. at 603,

64 S.Ct. at 288 (stating that the "return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks").

In any event, this court should not ordain the drastic risk shifting that Jersey Central advocates in its filing. The proper allocation of risk between shareholders and ratepayers is a serious ongoing question. *See supra* page 1202. It raises cross-cutting issues too broad to be ventilated in a single rate proceeding. "The importance of this issue . . . transcends the impact on a single jurisdictional utility." *New England Power Co.*, 32 FERC (CCH) ¶ 61,453, at 62,042 (Sept. 30, 1985). The majority's conclusion that the allocation reached by the Commission may be unconstitutional on the facts alleged has serious and troubling implications, especially for the twenty-five states that currently exclude cancelled facility expenses from a utility's rate base.

IV. Hearing on the Altered Rate Filing

As we have indicated, the Commission reasonably applied its settled rate base filing rule to Jersey Central according to its established summary disposition procedures. Nothing in Jersey Central's allegations automatically entitled it to a hearing. The utility was entitled to, and was afforded, a hearing on its proposed rate of return on the conforming items in its rate base. Jersey Central nevertheless makes one additional complaint against the Commission. In its final challenge, Jersey Central objects to the Commission's refusal to entertain the utility's attempt to inflate the rate of return proffered in its initial filing. This is yet another move by Jersey Central designed to convince this court to endorse its skirting of valid agency procedures.

In rejecting Jersey Central's plea, the Commission invoked its long-standing rule that "utilities may not present a 'moving target' by offering alternative justifications for previously filed rates." 20 FERC (CCH) ¶ 61,108, at 61,182. As this court noted in its original opinion, this rule is not arbitrary. It is justified by the "administrative necessity of closing the books at a time certain," as well as the need for a "mechanism to prevent utilities from delaying refund orders by offering alternative justifications for the rate increases [they have] filed. FPC staff and intervenors cannot be expected to follow a moving target." *New England Power Co. v. FPC*, No. 75-1379, slip op. at 3 (1st Cir. Nov. 13, 1975), *cited* in 20 FERC (CCH) ¶ 61,108, at 61,182.

The majority never questions the Commission's authority to implement this rule. Rather, it questions the appropriateness of its application in Jersey Central's case. The majority seems to believe that the Commission's refusal to grant a hearing on the higher rate of return stripped petitioner of any chance to plead its case and obtain the rates it desired. Despite the majority's protestations to the contrary, Jersey Central had sufficient opportunities to seek the revenues it requested. We are therefore unpersuaded by the utility's contention that it was denied a fair hearing.

As noted at the outset, the utility had at least two separate opportunities to raise its concerns and to request the full rate increase anticipated by its rejected filing. Either approach would have raised an issue of fact, precluding summary disposition. First, Jersey Central could have filed *initially* for a higher rate of return on its used and useful property, or for a shorter amortization period on its Forked River investment. Because a shorter amortization period would allow the utility to

recover its investment sooner, it would have had the same effect of increasing total return as did Jersey Central's attempt, flatly contradicted by the clear precedent in *NEPCO* and later cases, to increase the size of the rate base. Indeed, Jersey Central concedes this point. If the utility had followed *NEPCO*, and supported its proposed rate increase by filing for amortization of its investment in cancelled projects over five years instead of fifteen, rates higher than those it initially proposed would have been justified.

Second, Jersey Central could have made the same requests by *refiling* its rates, using a proper rate base. This new filing, of course, could not have stood alone without supporting exhibits and affidavits. As the Commission observed, "the company's [initial] case-in-chief did not include testimony seeking to support a return other than 19% based on any alternative scenario of events, including summary disposition of rate base items." 20 FERC (CCH) ¶ 61,108, at 61,182. In order to recover a higher return, petitioner would be required to offer cost and market data at the time of their filing that would support that rate of return. *See* 18 C.F.R. § 35.13(e) (1986) (testimony and exhibits supporting filing of changes in rate schedules).

Where the majority reads "in the [rehearing denial] order [that] the Commission made it clear a fresh filing would be futile" escapes comprehension. *See* Maj.Op. at 1187. The utility certainly did not get that message. The following exchange from *en banc* oral argument amplifies Jersey Central's recognition that it was free to submit a new rate filing and thereby obtain a hearing:

> COURT: But you could have put in a new filing, couldn't you?

> COUNSEL: We could have, sir, but . . .
>
> COURT: At any time, even now?
>
> COUNSEL: [W]e could but we believed then and we believe today that that precedent was wrong and we would not have had an opportunity to—
>
> COURT: That is really what I wanted to clear up. Your concern really is you strongly disagree with the *NEPCO* precedent—
>
> COUNSEL: Yes, we do, sir.
>
> COURT: —I understand that, but as far as you are concerned the use of the useful rule as applied in *NEPCO* is a bad idea and you would like this Court to change its mind.
>
> COUNSEL: Yes, sir, no question about it.

Tr. at 8.

As an alternative to submitting a different rate filing, Jersey Central could have asked for an individualized exemption from the *NEPCO* rule. The Commission's filing requirements provide that "[i]f any filing does not comply with any applicable statute, rule, or order, the filing may be rejected, unless the filing is accompanied by a motion requesting a waiver of the applicable requirement of a rule or order and the motion is granted." 18 C.F.R. § 385.2001(b)(1) (1986). By providing this waiver process, the Commission exercises its inherent power to relax, modify, or waive its filing requirements. *See Papago Tribal Utility Authority*, 628 F.2d at 247; *Municipal Electric Utility Association v. Federal Power Commission*, 485 F.2d 967, 975 n. 28 (D.C.Cir. 1973). Jersey Central did not move for such an exemption.

As its responses at oral argument illustrate, Jersey Central declined these multiple opportunities because it wanted to challenge the *NEPCO* rule directly, and none of

the permissible options allowed it to do so. The hearing it would have obtained had it made a new filing would not have enabled it to address the *NEPCO* doctrine; nor would the filing of a complying tariff in the first instance have provided that vantage. Similarly, merely asking for an exemption would in no way threaten the viability of the doctrine. The majority demonstrates that such a "characterization" of the utility's filings would be "an unreasonable one," Maj.Op. at 1185, but no characterization is necessary. Jersey Central plainly stated its purpose and acted upon it.

Jersey Central could have sought review of what it perceives as an unsound rule without trampling on the Commission's filing policies and procedures and without asking this court to become involved. It could have petitioned the Commission for a rulemaking. NEPCO took this approach in its 1985 submission for filing of a proposed rate increase. *See New England Power Co.*, 32 FERC (CCH) ¶ 61,454 (Sept. 30, 1985) (Phase II). NEPCO "request[ed] that the Commission reexamine its policy regarding the treatment of the costs of cancelled plant." *Id.* at 62,042 (citing *NEPCO*). Unlike Jersey Central, however, NEPCO did not factor its suggested treatment of abandoned plants into the rates it proposed; rather, it sought only a prospective change in the policy. *Id.* at 62,043 n. 5. In this way, the Commission was able to begin reexamining *NEPCO* "as well as the economic and legal underpinnings for a cancelled plant policy" in the rulemaking context. *Id.* at 62,042; *see also Pennsylvania Electric Co.*, 34 FERC (CCH) ¶ 61,141, 61,244 n. 8 (Feb. 4, 1986) ("[A]ny change in Commission policy would be prospective only, and utilities are required to adhere to the precedent established in [*NEPCO*] pending reconsideration of our policy."); *New England Power Co.*, 35 FERC (CCH) ¶ 61,353 (June 18, 1986) (denying motion to limit generic scope of NEPCO Phase II hearing).

In light of these opportunities, deliberately avoided, we cannot question the reasonableness of the Commission's application of its rule against presenting a "moving target." Of course, we do not suggest that an agency may implement any policy through any procedure, no matter how unreasonable, and compel the applicant to adhere to them in order to preserve its right to seek relief from the agency. We find only that the Commission acted validly in requiring Jersey Central to follow reasonable policy and filing requirements. The measure of their reasonableness is that they afforded Jersey Central ample opportunity to contend that, taking its balance sheet and troubled history of investments into account, the total return it requested was just and reasonable. They also provided the company with a platform for advocating the discontinued application of the used and useful doctrine to cancelled electric utility facilities. Given these opportunities, Jersey Central cannot seek from this court the relief and the individualized attention to its financial plight that it could have obtained from the Commission.

Conclusion

This is a case of modest proportions about one segment of the sweeping ratemaking responsibilities that Congress has entrusted to the Commission. Like all arms of the government, the agency must abide by its statutes and by the constitutional prohibition against taking property without due process of law. But the due process claims of a regulated utility are not coupons which can be exchanged for a hearing at a time, place,

and manner of the utility's choosing. Such an approach would wreak havoc with the agency's ability to administer a complex rate regulation system that must assess many rate filings annually.

There may indeed be times when the Commission is not free to employ the used and useful principle in a summary fashion. However, Jersey Central has not made the case for its exception. Its allegations do not raise a question of fact sufficient to trigger a *Hope* hearing before application of well-settled, court-approved ratemaking procedure and policy. The concerns about financial integrity and investor return that Jersey Central held in reserve for a hearing challenging the NEPCO rule should have been raised by following the Commission's established rules and procedures. We express no view on substantive rate-base requirements that may come before this court in another case; we find only that on these facts the Commission was not obligated to hold a hearing before entering its interim rate-reducing order. The Commission's administrative processes offered ample opportunities for Jersey Central to request and present supporting evidence for whichever rate of return and amortization period the utility deemed necessary to preserve its financial integrity, and to seek review of the *NEPCO* doctrine. Jersey Central chose not to avail itself of these opportunities, and now cries foul.

There is, in the end, only one reason that Jersey Central wants its hearing *before* the unamortized portion of its unproductive investment is excluded from the rate base. That timing is the only means it perceives as enabling it both to launch its frontal attack on the Commission's *NEPCO* doctrine and to immediately reap the rewards of any victory in the battle. The majority's

sympathy for Jersey Central appears driven by its agreement that the used and useful doctrine is outdated and should be replaced with a pure prudent investment approach. *See* Maj.Op. at 1175, 1180–81 & n. 2. By granting a hearing to Jersey Central at this stage of the long and complex ratemaking process, the majority provides the utility a forum in which to argue its causes. But it also interferes with the Commission's discretion in implementing ratemaking policies and procedures. It thereby threatens the well-held maxim that the Commission is "not bound to use any single formula or combination of formulae in determining rates." *See Hope*, 320 U.S. at 602, 64 S.Ct. at 287.

In an era of heightened deference to administrative decisions and procedures, this court especially ought to be sensitive to the line between legitimate judicial review and judicial substitutions for agency processes. *See Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984); *Vermont Yankee, supra.* The majority has reordered the very filing procedures that FERC may prescribe, has redirected the kinds of hearings in which FERC may consider changes in its policies and, worst of all, has thrust the courts back into the very complicated forest of making the rates that regulated industries may charge. We ignore at our peril the hard-learned lessons of restraint expressed by the Supreme Court in *Natural Gas Pipeline* and *Hope*. The majority would have us relive that painful period.

APPENDIX L

Excerpts from the Pennsylvania Public Utility Code

CHAPTER 13
RATES AND RATE MAKING

Sec.

1301. Rates to be just and reasonable.
1302. Tariffs; filing and inspection.
1303. Adherence to tariffs.
1304. Discrimination in rates.
1305. Advance payment of rates; interest on deposits.
1306. Apportionment of joint rates.
1307. Sliding scale of rates; adjustments.
1308. Voluntary changes in rates.
1309. Rates fixed on complaint; investigation of costs of production.
1310. Temporary rates.
1311. Valuation of and return on the property of a public utility.
1312. Refunds.
1313. Price upon resale of public utility services.
1314. Limitation on prices paid for property and fuel.
1315. Limitation on consideration of certain costs for electric utilities.
1316. Recovery of advertising expenses.
1316.1. Recovery of club dues.
1317. Regulation of natural gas costs.
1318. Determination of just and reasonable natural gas rates.
1319. Financing of energy supply alternatives.
1320. Fuel purchase audits by complaint.
1321. Recovery of certain employee meeting expenses.
1322. Outages of electric generating units.
1323. Procedures for new electric generating capacity.
1324. Residential telephone service rates based on duration on distance of call.
1325. Local exchange service increases; limitation.

Enactment. Chapter 13 was added July 1, 1978, P.L.598, No. 116, effective in 60 days.

§ 1301. Rates to be just and reasonable.

Every rate made, demanded, or received by any public utility, or by any two or more public utilities jointly, shall be just and reasonable, and in conformity with regulations or orders of the commission. Only public utility service being furnished or rendered by a municipal corporation, or by the operating agencies of any municipal corporation, beyond its corporate limits, shall be subject to regulation and control by the commission as to rates, with the same force, and in like manner, as if such service were rendered by a public utility.

§ 1302. Tariffs; filing and inspection.

Under such regulations as the commission may prescribe, every public utility shall file with the commission, within such time and in such form as the commission may designate, tariffs showing all rates established by it and collected or enforced, or to be collected or enforced, within the jurisdiction of the commission. The tariffs of any public utility also subject to the jurisdiction of a Federal regulatory body shall correspond, so far as practicable, to the form of those prescribed by such Federal regulatory body. Every public utility shall keep copies of such tariffs open to public inspection under such rules and regulations as the commission may prescribe. One copy of any rate filing shall be made available, at a convenient location and for a reasonable length of time within each of the utilities' service areas, for inspection and study by customers, upon request to the utility.

(Dec. 21, 1984, P.L.1265, No.240, eff. imd.)

§ 1303. Adherence to tariffs.

No public utility shall, directly or indirectly, by any device whatsoever, or in anywise, demand or receive from any person, corporation, or municipal corporation a greater or less rate for any service rendered or to be rendered by such public utility than that specified in the tariffs of such public utility applicable thereto. The rates specified in such tariffs shall be the lawful rates of such public utility until changed, as provided in this part. Any public utility, having more than one rate applicable to service rendered to a patron, shall, after notice of service conditions, compute bills under the rate most advantageous to the patron.

§ 1304. Discrimination in rates.

No public utility shall, as to rates, make or grant any unreasonable preference or advantage to any person, corporation, or municipal corporation, or subject any person, corporation, or municipal corporation to any unreasonable prejudice or disadvantage. No public utility shall establish or maintain any unreasonable difference as to rates, either as between localities or as between classes of service. Unless specifically authorized by the commission, no public utility shall make, demand, or receive any greater rate in the aggregate for the transportation of passengers or property of the same class, or for the transmission of any message or conversation for a shorter than for a longer distance over the same line or route in the same direction, the shorter being included within the longer distance, or any greater rate as a through rate than the aggregate of the intermediate rates. This section does not prohibit the establishment of reasonable zone or group systems, or classifications of rates or, in the case of common car-

riers, the issuance of excursion, commutation, or other special tickets at special rates, or the granting of non-transferable free passes, or passes at a discount to any officer, employee, or pensioner of such common carrier. No rate charged by a municipality for any public utility service rendered or furnished beyond its corporate limits shall be considered unjustly discriminatory solely by reason of the fact that a different rate is charged for a similar service within its corporate limits.

§ 1305. Advance payment of rates; interest on deposits.

No public utility shall require the payment of rates in advance, or the making of minimum payments, ready to serve charges, or deposits to secure future payments of rates, except as the commission, by regulation or order, may permit. Any deposit made by any domestic consumer, under the provisions of this section or under any repealed statute supplied by this part, shall be returned with any interest due thereon to the consumer making such deposit when he shall have paid undisputed bills for service over a period of 12 consecutive months.

§ 1306. Apportionment of joint rates.

Where public utilities entitled to share in any joint rate shall be unable to agree upon the division thereof, or shall make any unjust or unreasonable division or apportionment thereof, the commission may, after hearing, upon its own motion or upon complaint, fix the proportion to which each public utility shall be entitled.

§ 1307. Sliding scale of rates; adjustments.

(a) General rule.—Any public utility, except common carriers and those natural gas distributors with gross intrastate annual operating revenues in excess of

$40,000,000 with respect to the gas costs of such natural gas distributors, may establish a sliding scale of rates or such other method for the automatic adjustment of the rates of the public utility as shall provide a just and reasonable return on the rate base of such public utility, to be determined upon such equitable or reasonable basis as shall provide such fair return. A tariff showing the scale of rates under such arrangement shall first be filed with the commission, and such tariff, and each rate set out therein, approved by it. The commission may revoke its approval at any time and fix other rates for any such public utility if, after notice and hearing, the commission finds the existing rates unjust or unreasonable.

(b) Mandatory system for automatic adjustment.—The commission, by regulation or order, upon reasonable notice and after hearing, may prescribe for any class of public utilities, except common carriers and those natural gas distributors with gross intrastate annual operating revenues in excess of $40,000,000, a mandatory system for the automatic adjustment of their rates, by means of a sliding scale of rates or other method, on the same basis as provided in subsection (a), to become effective when and in the manner prescribed in such regulation or order. Every such public utility shall, within such time as shall be prescribed by the commission, file tariffs showing the rates established in accordance with such regulation or order.

(c) Fuel cost adjustment.—In any method automatically adjusting rates to reflect changes in fossil fuel cost under this section, the fuel cost used in computing the adjustment shall be limited, in the case of an electric utility, to the cost of such fuel delivered to the utili-

ty at the generating site at which it is to be consumed, and the cost of disposing of solid waste from scrubbers or other devices designed so that the consumption of Pennsylvania-mined coal at the generating site would comply with the sulfur oxide emission standards prescribed by the Commonwealth. The cost of fuel handling after such delivery, or of waste disposal, other than as prescribed in this section, shall be excluded from such computation. In any method automatically adjusting rates to reflect changes in fuel cost other than fossil fuel cost under this section, the fuel cost used in computing the adjustment shall be limited, in the case of an electric utility, to the cost of such fuel delivered to the utility at the generating site at which it is to be consumed after deducting therefrom the present salvage or reuse value of such fuel, as shall be established by commission rule or order.

(d) Fuel cost adjustment audits.—The commission shall conduct or cause to be conducted, at such times as it may order, but at least annually, an audit of each public utility which, by any method described in this section, automatically adjusts its rates to reflect changes in its fuel costs, which audit shall enable the commission to determine the propriety and correctness of amounts billed and collected under this section. Whoever performs the audit shall be a person knowledgable in the subject matter encompassed within the operation of the automatic adjustment clause. The auditors report shall be in a form and manner directed by the commission.

(e) Automatic adjustment reports and proceedings.—

(1) Within 30 days following the end of such 12-month period as the commission shall designate, each public utility using an automatic adjustment

clause shall file with the commission a statement which shall specify for such period:

(i) the total revenues received pursuant to the automatic adjustment clause;

(ii) the total amount of that expense or class or expenses incurred which is the basis of the automatic adjustment clause; and

(iii) the difference between the amounts specified by subparagraphs (i) and (ii).

Such report shall be a matter of public record and copies thereof shall be made available to any person upon request to the commission.

(2) Within 60 days following the submission of such report by a public utility, the commission shall hold a public hearing on the substance of the report and any matters pertaining to the use by such public utility of such automatic adjustment clause in the preceding period and may include the present and subsequent period.

(3) Absent good reason being shown to the contrary, the commission shall, within 60 days following such hearing, by order direct each such public utility to, over an appropriate 12-month period, refund to its patrons an amount equal to that by which its revenues received pursuant to such automatic adjustment clause exceeded the amount of such expense or class of expenses, or recover from its patrons an amount equal to that by which such expense or class of expenses exceeded the revenues received pursuant to such automatic adjustment clause.

(4) For the purpose of this subsection, where a 12-month report period and 12-month refund or recovery period shall have been previously established or designated, nothing in this section shall impair the continued use of such previously estab-

lished or designated periods nor shall anything in this section prevent the commission from amending at any time any method used by any utility in automatically adjusting its rates, so as to provide the commission more adequate supervision of the administration by a utility of such method and to decrease the likelihood of collection by a utility, in subsequent periods, of amounts greater or less than that to which it is entitled, or, in the event that such deficiency or surplus in collected amounts is found, more prompt readjustment thereof.

(f) Recovery of natural gas costs.—

(1) Natural gas distributors with gross intrastate annual operating revenues in excess of $40,000,000 may file tariffs reflecting increases or decreases in their natural gas costs and the tariffs shall have an effective date six months from the date of filing. The commission shall promulgate regulations establishing the time and manner of such filing, but no such natural gas utility shall voluntarily file more than one such tariff in a 12-month period: Provided, That nothing contained herein shall prohibit any party from advising the commission that there has been or there is anticipated to be a significant difference between the natural gas costs to the utility and the costs reflected in the then effective tariff or the commission from acting upon such advice.

(2) The commission shall hold a hearing or hearings, with notice, to investigate the tariffs. Where there has been an indication of consumer interest, the hearing shall be held in the service territory of the natural gas distributor. Prior to the effective date of the filing, the commission shall issue an order establishing the rate to be charged to reflect such increases or decreases in natural gas costs. Rates established under this subsection do not constitute either a sliding scale of rates or an automatic adjustment subject to the prohibitions in subsections (a) and (b). Such rates, however, are subject to the same kinds of audits, reports and proceedings required by subsection (d).

(3) Within 60 days following the end of such 12-month period as the commission shall designate, each public utility subject to this subsection shall file with the commission a statement which specifies for such period:

(i) The total revenues received pursuant to this section.

(ii) The total gas expense incurred.

(iii) The difference between the amounts specified by subparagraphs (i) and (ii).

(iv) Evidence explaining how actual costs incurred differ from the costs allowed under paragraph (2) and why such differences occurred.

(v) How these costs are consistent with a least cost procurement policy as required by section 1318 (relating to determination of just and reasonable natural gas rates).

Such report shall be a matter of public record and copies thereof shall be made available by the gas distributor to any person upon request. Copies of the reports shall be filed with the Office of Consumer Advocate at the same time as they are filed with the commission.

(4) The commission shall hold a public hearing on the substance of such statement submitted by a utility as required in paragraph (3) and on any related matters.

(5) The commission, after hearing, shall determine the portion of the companies' actual gas costs in the previous 12-month period which meet the standards set out in section 1318. The commission

shall, by order, direct each gas utility subject to this subsection to refund to its patrons any gas revenues collected pursuant to paragraph (2) which exceed the amount of actual gas expenses incurred consistent with the standards in section 1318 and to recover from its patrons any amount by which the actual gas expenses, which have been incurred consistent with the standards in section 1318, exceed the revenues collected pursuant to paragraph (2). Absent good reason to the contrary, the commission shall issue its order within six months following the filing of the statement described in paragraph (3). Refunds to patrons shall be made with interest, which shall be the average rate of interest specified for residential mortgage lending by the Secretary of Banking in accordance with the act of January 30, 1974 (P.L.13, No.6), referred to as the Loan Interest and Protection Law, during the period or periods for which the commission orders refunds: Provided, That nothing contained herein shall limit the applicability of any defenses, principles or doctrines which would prohibit the commission's inquiry into any matters that were decided finally in the commission's order issued under paragraph (2).

(g) Definition.—As used in this section the term "natural gas" includes natural gas, liquified natural gas, synthetic natural gas and any natural gas substitutes.

(May 31, 1984, P.L.370, No.74, eff. 60 days; Sept. 27, 1984, P.L.721, No.153, eff. 60 days; Dec. 21, 1984, P.L.1265, No.240, eff. imd.)

1984 Amendments. Act 74 amended subsecs. (a) and (b) and added subsecs. (f) and (g), Act 153 amended subsec. (a) and Act 240 amended subsecs. (a) and (f). The amendments by Acts 153 and 240 to subsec. (a) are identical. See section 5 of Act 74 and section 7 of Act 240 in the appendix to this title for special provisions relating to applicability.

Cross References. Section 1307 is referred to in sections 1317, 1318 of this title.

§ 1308. Voluntary changes in rates.

(a) General rule.—Unless the commission otherwise orders, no public utility shall make any change in any existing and duly established rate, except after 60 days notice to the commission, which notice shall plainly state the changes proposed to be made in the rates then in force, and the time when the changed rates will go into effect. The public utility shall also give such notice of the proposed changes to other interested persons as the commission in its discretion may direct. Such notices regarding the proposed changes which are provided to the utility's customers shall be in plain understandable language as the commission shall prescribe. All proposed changes shall be shown by filing new tariffs, or supplements to existing tariffs filed and in force at the time. The commission, for good cause shown, may allow changes in rates, without requiring the 60 days notice, under such conditions as it may prescribe.

(b) Hearing and suspension of rate change.—Whenever there is filed with the commission by any public utility any tariff stating a new rate, the commission may, either upon complaint or upon its own motion, upon reasonable notice, enter upon a hearing concerning the lawfulness of such rate, and pending such hearing and the decision thereon, the commission, upon filing with such tariff and delivering to the public utility affected thereby a statement in writing of its reasons therefor, may, at any time before it becomes effective, suspend the operation of such rate for a period not longer than six months from the time such rate would otherwise become effective, and an additional period of

not more than three months pending such decision. The rate in force when the tariff stating the new rate was filed shall continue in force during the period of suspension, unless the commission shall establish a temporary rate as authorized in section 1310 (relating to temporary rates). The commission shall consider the effect of such suspension in finally determining and prescribing the rates to be thereafter charged and collected by such public utility. This subsection shall not apply to any tariff stating a new rate which constitutes a general rate increase as defined in subsection (d).

(c) Determination.—If, after such hearing, the commission finds any such rate to be unjust or unreasonable, or in anywise in violation of law, the commission shall determine the just and reasonable rate to be charged or applied by the public utility for the service in question, and shall fix the same by order to be served upon the public utility and such rate shall thereafter be observed until changed as provided by this part.

(d) General rate increases.—Whenever there is filed with the commission by any public utility described in paragraph (1)(i), (ii), (vi) or (vii) of the definition of "public utility" in section 102 (relating to definitions), and such other public utility as the commission may by rule or regulation direct, any tariff stating a new rate which constitutes a general rate increase, the commission shall promptly enter into an investigation and analysis of said tariff filing and may by order setting forth its reasons therefor, upon complaint or upon its own motion, upon reasonable notice, enter upon a hearing concerning the lawfulness of such rate, and the commission may, at any time by vote of a majority of the members of the commission serving in accordance with law, permit such tariff to become effective, except that

absent such order such tariff shall be suspended for a period not to exceed seven months from the time such rate would otherwise become effective. Before the expiration of such seven-month period, a majority of the members of the commission serving in accordance with law, acting unanimously, shall make a final decision and order, setting forth its reasons therefor, granting or denying, in whole or in part, the general rate increase requested. If, however, such an order has not been made at the expiration of such seven-month period, the proposed general rate increase shall go into effect at the end of such period, but the commission may by order require the interested public utility to refund, in accordance with section 1312 (relating to refunds), to the persons in whose behalf such amounts were paid, such portion of such increased rates as by its decision shall be found not justified, plus interest, which shall be the average rate of interest specified for residential mortgage lending by the Secretary of Banking in accordance with the act of January 30, 1974 (P.L.13, No.6), referred to as the Loan Interest and Protection Law, during the period or periods for which the commission orders refunds. The rate in force when the tariff stating such new rate was filed shall continue in force during the period of suspension unless the commission shall grant extraordinary rate relief as prescribed in subsection (e). The commission shall consider the effect of such suspension in finally determining and prescribing the rates to be thereafter charged and collected by such public utility, except that the commission shall have no authority to prescribe, determine or fix, at any time during the pendency of a general rate increase proceeding or prior to a final determination of a general rate increase request, temporary rates as provided in section 1310,

which rates may provide retroactive increases through recoupment. As used in this part general rate increase means a tariff filing which affects more than 5% of the customers and amounts to in excess of 3% of the total gross annual intrastate operating revenues of the public utility. If the public utility furnishes two or more types of service, the foregoing percentages shall be determined only on the basis of the customers receiving, and the revenues derived from, the type of service to which the tariff filing pertains.

(d.1) Multiple filings prohibited.—Except as required to implement an order granting extraordinary rate relief, no public utility which has filed a general rate increase request pursuant to this section shall file an additional general rate increase request pursuant to this section for the same type of service until the commission has made a final decision and order on the prior general rate increase request or until the expiration of the maximum period of suspension of the prior general rate increase request pursuant to this section, whichever is earlier.

(e) Extraordinary rate relief.—Upon petition to the commission at the time of filing of a rate request or at any time during the pendency of proceedings on such rate request, any public utility may seek extraordinary rate relief of such portion of the total rate relief requested as can be shown to be immediately necessary for the maintenance of financial stability in order to enable the utility to continue providing normal services to its customers, avoid reductions in its normal maintenance programs, avoid substantially reducing its employment, and which will provide no more than the rate of return on the utility's common equity established by

the commission in consideration of the utility's preceding rate filing, except that no utility shall file, either with a request for a general rate increase or at any time during the pendency of such a request, more than one petition under this subsection pertaining to rates for a particular type of service, nor any supplement or amendment thereto, except when permitted to do so by order of the commission. Any public utility requesting extraordinary rate relief shall file with the petition sufficient additional testimony and exhibits which will permit the commission to make appropriate findings on the petition. The public utility shall give notice of the petition in the same manner as its filing upon which this petition is based. The commission shall within 30 days from the date of the filing of a petition for extraordinary rate relief, and after hearing for the purpose of cross-examination of the testimony and exhibits of the public utility, and the presentation of such other evidentiary testimony as the commission may by rule prescribe, by order setting forth its reasons therefor, grant or deny, in whole or in part, the extraordinary relief requested. Absent such order, the petition shall be deemed to have been denied. Rates established pursuant to extraordinary rate relief shall not be deemed to be temporary rates within the meaning of that term as it is used in section 1310.

(f) Limitation on rate increases by certain public utilities.—Whenever there is filed with the commission any tariff stating a new rate based in whole or in part on the cost of constructing an electric generating unit, the commission shall compare the estimated construction cost filed in accordance with section 515(a) (relating to construction cost of electric generating units)

with the actual construction cost submitted by the utility in support of that tariff. If the actual construction cost exceeds the estimated construction cost, the rate determined by the commission under this section shall not be based on any part of that excess unless the public utility proves that part of the excess to have been necessary and proper. In making its determination under this subsection, the commission shall consider all relevant and material evidence, including evidence obtained pursuant to section 515. For purposes of this subsection "construction" includes any work performed on an electric generating unit which required, or is expected to require, the affected public utility to incur an aggregate of at least $100,000,000 of expenses which, in accordance with generally accepted accounting principles, are capital expenses and not operating or maintenance expenses.

(July 6, 1984, P.L.602, No.123, eff. imd.; Sept. 27, 1984, P.L.721, No.153, eff. imd.; Dec. 21, 1984, P.L.1265, No.240, eff. imd.)

1984 Amendments. Act 123 added subsec. (f), Act 153 added subsec. (d.1) and Act 240 amended subsec. (a) and added subsec. (d.1). The amendments by Acts 153 and 240, adding subsec. (d.1), are substantially the same and both have been given effect in setting forth the text of subsec (d.1). See section 5 of Act 123 in the appendix to this title for special provisions relating to submission of cost estimate for units not completed.

Cross References. Section 1308 is referred to in sections 306, 523, 1316, 1318, 1325 of this title.

§ 1309. Rates fixed on complaint; investigation of costs of production.

Whenever the commission, after reasonable notice and hearing, upon its own motion or upon complaint,

finds that the existing rates of any public utility for any service are unjust, unreasonable, or in anywise in violation of any provision of law, the commission shall determine the just and reasonable rates, including maximum or minimum rates, to be thereafter observed and in force, and shall fix the same by order to be served upon the public utility, and such rates shall constitute the legal rates of the public utility until changed as provided in this part. Whenever a public utility does not itself produce or generate that which it distributes, transmits, or furnishes to the public for compensation, but obtains the same from another source, the commission shall have the power and authority to investigate the cost of such production or generation in any investigation of the reasonableness of the rates of such public utility.

Cross References. Section 1309 is referred to in sections 514, 521 of this title.

§ 1310. Temporary rates.

(a) General rule.—The commission may, in any proceeding involving the rates of a public utility, except a proceeding involving a general rate increase, brought either upon its own motion or upon complaint, after reasonable notice and hearing, if it be of opinion that the public interest so requires, immediately fix, determine, and prescribe temporary rates to be charged by such public utility, pending the final determination of such rate proceeding. Such temporary rates, so fixed, determined, and prescribed, shall be sufficient to provide a return of not less than 5% upon the original cost, less accrued depreciation, of the physical property, when first devoted to public use, of such public utility, used and useful in the public service, and if the duly verified reports of such public utility to the commission do not

show such original cost, less accrued depreciation, of such property, the commission may estimate such cost less depreciation and fix, determine, and prescribe rates as hereinbefore provided.

(b) Exception where records unavailable.—If any public utility does not have continuing property records, kept in the manner prescribed by the commission under the provisions of section 1702 (relating to continuing property records), then the commission, after reasonable notice and hearing, may establish temporary rates which shall be sufficient to provide a return of not less than an amount equal to the operating income for such prior calendar, fiscal or other year as the commission may deem proper, to be determined on the basis of data appearing in the annual report of such public utility to the commission for such prior year as the commission may deem proper, plus or minus such return as the commission may prescribe from time to time upon such net changes of the physical property as are reported to and approved for rate-making purposes by the commission. In determining the net changes of the physical property, the commission may, in its discretion, deduct from gross additions to such physical property the amount charged to operating expenses for depreciation or, in lieu thereof, it may determine such net changes by deducting retirements from the gross additions. The commission, in determining the basis for temporary rates, may make such adjustments in the annual report data as may, in the judgment of the commission, be necessary and proper.

(c) Periodicity of rates.—The commission may fix, determine, and prescribe temporary rates every month, or at any other interval, if it be of opinion that the public interest so requires, and the existence of proceedings begun for the purpose of establishing final rates shall not prevent the commission from changing every month, or at any other interval, such temporary rates as it has previously fixed, determined, and prescribed.

(d) Excessive rates.—Whenever the commission, upon examination of any annual or other report, or of any papers, records, books, or documents, or of the property of any public utility, shall be of opinion that any rates of such public utility are producing a return in excess of a fair return upon the fair value of the property of such public utility, used and useful in its public service, the commission may, by order, prescribe for a trial period of a least six months, which trial period may be extended for one additional period of six months, such temporary rates to be observed by such public utility as, in the opinion of the commission, will produce a fair return upon such fair value, and the rates so prescribed shall become effective upon the date specified in the order of the commission. Such rates, so prescribed, shall become permanent at the end of such trial period, or extension thereof, unless at any time during such trial period, or extension thereof, the public utility involved shall complain to the commission that the rates so prescribed are unjust or unreasonable. Upon such complaint, the commission, after hearing, shall determine the issues involved, and pending final determination the rates so prescribed shall remain in effect.

(e) Effect and adjustment of rates.—Temporary rates so fixed, determined, and prescribed under this section shall be effective until the final determination of the rate proceeding, unless terminated sooner by the commission. In every proceeding in which temporary rates are fixed, determined, and prescribed under this section,

the commission shall consider the effect of such rates in fixing, determining, and prescribing rates to be thereafter demanded or received by such public utility on final determination of the rate proceeding.

Effective Date. Section 3 of Act 116 of 1978 provided that the provisions of section 1310, insofar as they are different from the law repealed by Act 116, shall take effect October 7, 1977.

Cross References. Section 1310 is referred to in sections 306, 1308 of this title.

§ 1311. Valuation of and return on the property of a public utility.

(a) Valuation generally.—The commission may, after reasonable notice and hearing, ascertain and fix the value of the whole or any part of the property of any public utility, insofar as the same is material to the exercise of the jurisdiction of the commission, and may make revaluations from time to time in the value of rate base of a public utility on account of all new construction, extensions, additions and retirements to the property of any public utility.

(b) Method of valuation.—The value of the property of the public utility included in the rate base shall be the original cost of the property when first devoted to the public service less the applicable accrued depreciation as such depreciation is determined by the commission.

(c) Segregation of property.—When any public utility furnishes more than one of the different types of utility service, the commission shall segregate the property used and useful in furnishing each type of such service, and shall not consider the property of such public utility as a unit in determining the value of the rate base of such public utility for the purpose of fixing rates.

(d) Common carriers.—In fixing any rate of a public utility engaged exclusively as a common carrier by motor vehicle, the commission may, in lieu of other standards established by law, fix the fair return by relating the fair and reasonable operating expenses, depreciation, taxes and other costs of furnishing service to operating revenues.

(Sept. 27, 1984, P.L. 721, No. 153, eff. 60 days; Dec. 21, 1984, P.L. 1265, No. 240, eff. imd.)

1984 Amendments. Acts 153 and 240 amended the entire section. Act 240 overlooked the amendment by Act 153 but the amendments do not conflict in substance and have been given effect in setting forth the text of the section.

§ 1312. Refunds.

(a) General rule.—If, in any proceeding involving rates, the commission shall determine that any rate received by a public utility was unjust or unreasonable, or was in violation of any regulation or order of the commission, or was in excess of the applicable rate contained in an existing and effective tariff of such public utility, the commission shall have the power and authority to make an order requiring the public utility to refund the amount of any excess paid by any patron, in consequence of such unlawful collection, within four years prior to the date of the filing of the complaint, together with interest at the legal rate from the date of each such excessive payment. In making a determination under this section, the commission need not find that the rate complained of was extortionate or oppressive. Any order of the commission awarding a refund shall be made for and on behalf of all patrons subject to the same rate of the public utility. The commission shall state in any refund order the exact amount to be

paid, the reasonable time within which payment shall be made, and shall make findings upon pertinent questions of fact.

(b) Suit for refund.—If the public utility fails to make refunds within the time for payment fixed by any final order of the commission or court, any patron entitled to any refund may sue therefor and the findings and order made by the commission shall be prima facie evidence of the facts therein stated, and that the amount awarded is justly due the plaintiff in such suit, and the defendant public utility shall not be permitted to avail itself of the defense that the service was, in fact, rendered to the plaintiff at the rate contained in its tariffs in force at the time payment was made and received, nor shall the defendant public utility be permitted to avail itself of the defense that the rate was reasonable. Any patron entitled to any refund shall be entitled to recover, in addition to the amount of refund, a penalty of 50% of the amount of such refund, together with all court costs and reasonable attorney fees. No suit may be maintained for a refund unless instituted within one year from the date of the order of the commission or court. Any number of patrons entitled to such refund may join as plaintiffs and recover their several claims in a single action, in which action the court shall render a judgment severally for each plaintiff as his interest may appear.

(c) Conditions for suit.—No action shall be brought in any court for a refund, unless and until the commission shall have determined that the rate in question was unjust or unreasonable, or in violation of any regulation or order of the commission, or in excess of the applicable rate contained in an existing and effective tariff, and

then only to recover such refunds as may have been awarded and directed to be paid by the commission in such order.

Cross References. Section 1312 is referred to in section 1308 of this title.

§ 1313. Price upon resale of public utility services.

Whenever any person, corporation or other entity, not a public utility, electric cooperative corporation, municipality authority or municipal corporation, purchases service from a public utility and resells it to consumers, the bill rendered by the reseller to any residential consumer shall not exceed the amount which the public utility would bill its own residential consumers for the same quantity of service under the residential rate of its tariff then cuurently in effect.

Cross References. Section 1313 is referred to in section 3313 of this title.

§ 1314. Limitation on prices paid for property and fuel.

The commission shall adopt regulations prohibiting public utilities subject to its jurisdiction from paying for or agreeing to pay for goods, services, equipment or fuels at prices in excess of those contained in contracts existing between the utilities and providers of such goods, services, equipment or fuel services.
(Nov. 26, 1978, No.297, eff. 60 days)

1978 Amendment. Act 297 added section 1314.

§ 1315. Limitation on consideration of certain costs for electric utilities.

Except for such nonrevenue producing, nonexpense reducing investments as may be reasonably shown to be necessary to improve environmental conditions at exist-

ing facilities or improve safety at existing facilities or as may be required to convert facilities to the utilization of coal, the cost of construction or expansion of a facility undertaken by a public utility producing, generating, transmitting, distributing or furnishing electricity shall not be made a part of the rate base nor otherwise included in the rates charged by the electric utility until such time as the facility is used and useful in service to the public. Except as stated in this section, no electric utility property shall be deemed used and useful until it is presently providing actual utility service to the customers.

(Dec. 30, 1982, P.L.1473, No.335, eff. imd.)

1982 Amendment. Act 335 added section 1315. Section 2 of Act 335 provided that the act shall be applicable to all proceedings pending before the Public Utility Commission and the courts at this time and also provided that nothing contained in the act shall be construed to modify or change existing law with regard to rate making treatment of investment in facilities of fixed utilities other than electric utilities.

Cross References. Section 1315 is referred to in sections 514, 521, 1319 of this title.

§ 1316. Recovery of advertising expenses.

(a) General rule.—For purposes of rate determinations, no public utility may charge to its consumers as a permissible operating expense for ratemaking purposes any direct or indirect expenditure by the utility for political advertising. The commission shall also disallow as operating expense for ratemaking purposes expenditures for other advertising, unless and only to the extent that the commission finds that such advertising is reasonable and meets one or more of the following criteria:

(1) Is required by law or regulation.

(2) Is in support of the issuance, marketing or acquisition of securities or other forms of financing.

(3) Encourages energy independence by promoting the wise development and use of domestic sources of coal, oil or natural gas and does not promote one method of generating electricity as preferable to other methods of generating electricity.

(4) Provides important information to the public regarding safety, rate changes, means of reducing usage or bills, load management or energy conservation.

(5) Provides a direct benefit to ratepayers.

(6) Is for the promotion of community service or economic development.

(b) Charging expenses to stockholders.—Any direct or indirect expenditure by a public utility for political advertising, or any other advertising not meeting the criteria set forth in subsection (a), shall be charged to its stockholders and shall not be included as an operating expense for ratemaking purposes.

(c) Filing of information and materials.—Whenever a public utility proposes a change in rates under section 1308 (relating to voluntary changes in rates), the public utility shall file with the commission a listing of each type of advertising prepared, distributed or presented by the public utility or to be prepared, distributed or presented by the public utility during the test year utilized by the public utility in discharging its burden of proof, and a listing of each type of advertising prepared, distributed or presented by the public utility during the year immediately preceding the test year, as well as an accounting of the expenditures by the public utility for such advertising, to the extent such advertis-

ing is proposed to be included as operating expense for ratemaking purposes. The filing requirements imposed by this subsection shall not be construed to limit the right of any party to discovery under this or any other provision of law.

(d) Definition.—As used in this section the term "political advertising" means any advertising for the purpose of influencing public opinion with respect to any legislative, administrative action or candidate election or with respect to any controversial issue to be decided by public voting. The term includes money spent for lobbying but not money spent for appearances before regulatory or other governmental bodies in connection with a public utility's existing or proposed operations.
(Mar. 7, 1984, P.L.104, No.22, eff. 60 days; July 10, 1986, P.L.1238, No.114, eff.imd.)

§ 1316.1. Recovery of club dues.

No public utility may charge to its customers as a permissible operating expense for ratemaking purposes membership fees, dues or charges to fraternal, social or sports clubs or organizations.
(July 10, 1986, P.L.1238, No.114, eff.imd.)

1986 Amendment. Act 114 added section 1316.1.

§ 1317. Regulation of natural gas costs.

(a) General rule.—In every rate proceeding instituted by a natural gas distribution utility, pursuant to section 1307(f) (relating to sliding scale of rates; adjustments), each such utility shall be required to provide to the commission such information, to be established by commission regulation within 120 days of the passage of this section, that will permit the commission to make specific findings as to whether the utility is pursuing a least cost fuel procurement policy, consistent with the utility's obligation to provide safe, adequate and reliable service to its customers. Such information shall include, but need not be limited to, information, data and statements regarding:

(1) The utility's participation in rate proceedings before the Federal Energy Regulatory Commission which affect the utility's gas costs.

(2) The utility's efforts to negotiate favorable contracts with gas suppliers and to renegotiate existing contracts with gas suppliers or take legal actions necessary to relieve the utility from existing contract terms which are or may be adverse to the interests of the utility's ratepayers.

(3) The utility's efforts to secure lower cost gas supplies both within and outside of the Commonwealth, including the use of transportation arrangements with pipelines and other gas distribution companies.

(4) The sources and amounts of all gas supplies which have been withheld or have been caused to be withheld from the market by the utility and the reasons why such gas is not to be utilized.

(b) Integrated gas companies.—In the case of a natural gas distribution utility which purchases all or part of its gas supplies from an affiliated interest, as that term is defined in section 2101 (relating to definition of affiliated interest), such utility shall, in addition to the materials required in subsection (a), be required to provide to the commission such information, to be established by commission regulation within 120 days of the passage of this section, that will permit the commission to make specific findings as to whether any purchases of gas from an affiliated interest are consistent with a least cost fuel procurement policy, consistent

with the utility's obligation to provide safe, adequate and reliable service to its customers. Such information shall include, but need not be limited to, statements regarding:

(1) Efforts made by the utility to obtain gas supplies from nonaffiliated interests.

(2) The specific reasons why the utility has purchased gas supplies from an affiliated interest and demonstration that such purchases are consistent with a least cost fuel procurement policy.

(3) The sources and amounts of all gas supplies which have been withheld from the market by the utility or any affiliated interest and the reasons why such gas is not being utilized.

(c) Definition.—As used in this section the term "natural gas" includes natural gas, liquified natural gas, synthetic natural gas and any natural gas substitutes.
(May 31, 1984, P.L.370, No.74, eff. 60 days)

1984 Amendment. Act 74 added section 1317. See section 5 of Act 74 in the appendix to this title for special provisions relating to applicability.

Cross References. Section 1317 is referred to in sections 1318, 2107 of this title.

§ 1318. Determination of just and reasonable natural gas rates.

(a) General rule.—In establishing just and reasonable rates for those gas distribution utilities with gross intrastate operating revenues in excess of $40,000,000 under section 1307(f) (relating to sliding scale of rates; adjustments) or 1308(d) (relating to voluntary changes in rates) or any other rate proceeding, the commission shall consider the materials provided by the utilities pursuant to section 1317 (relating to regulation of natural gas costs). No rates for a natural gas distribution utility shall be deemed just and reasonable unless the commission finds that the utility is pursuing a least cost fuel procurement policy, consistent with the utility's obligation to provide safe, adequate and reliable service to its customers. In making such a determination, the commission shall be required to make specific findings which shall include, but need not be limited to, findings that:

(1) The utility has fully and vigorously represented the interests of its ratepayers in proceedings before the Federal Energy Regulatory Commission.

(2) The utility has taken all prudent steps necessary to negotiate favorable gas supply contracts and to relieve the utility from terms in existing contracts with its gas suppliers which are or may be adverse to the interests of the utility's ratepayers.

(3) The utility has taken all prudent steps necessary to obtain lower cost gas supplies on both short-term and long-term bases both within and outside the Commonwealth, including the use of gas transportation arrangements with pipelines and other distribution companies.

(4) The utility has not withheld from the market or caused to be withheld from the market any gas supplies which should have been utilized as part of a least cost fuel procurement policy.

(b) Limitation on gas purchased from affiliates.—In any instance in which a gas distribution utility purchases all or part of its gas supplies from an affiliated interest, as that term is defined in section 2101 (relating to definition of affiliated interest), the commission, in addition to the determinations and findings set forth in subsection (a), shall be required to make specific

findings with regard to the justness and reasonableness of all such purchases. Such findings shall include, but not be limited to findings:

(1) That the utility has fully and vigorously attempted to obtain less costly gas supplies on both short-term and long-term bases from nonaffiliated interests.

(2) That each contract for the purchase of gas from its affiliated interest is consistent with a least cost fuel procurement policy.

(3) That neither the utility nor its affiliated interest has withheld from the market any gas supplies which should have been utilized as part of a least cost fuel procurement policy.

(c) Shut-in gas; special rule.—In determining whether a gas utility has purchased the least costly natural gas available, the commission shall consider as available to the utility any gas supplies that reasonably could have been brought to market during the relevant period but which were voluntarily withheld from the market by the utility or an affiliated interest of the utility.

(d) Other regulatory approvals.—The fact that a contract or rate has been approved by a Federal regulatory agency for interstate ratemaking purposes shall not, in and of itself, be adequate to satisfy the utility's burden of proof that gas prices and volumes associated with such contract or rate are just and reasonable for purposes of this section.

(e) Reports.—Each natural gas distribution utility with gross intrastate annual operating revenues in excess of $40,000,000 shall file with the commission and the Office of Consumer Advocate, in accordance with regulations to be prescribed by the commission, quarterly reports setting forth the actual gas costs incurred by the utility on a monthly basis. Actual gas costs shall be reviewed for their accuracy by the Bureau of Audits at least annually and the results of that review shall be submitted to the commission.

(f) Definition.—As used in this section the term "natural gas" includes natural gas, liquified natural gas, synthetic natural gas and any natural gas substitutes. (May 31, 1984, P.L.370, No.74, eff. 60 days)

1984 Amendment. Act 74 added section 1318. See section 5 of Act 74 in the appendix to this title for special provisions relating to applicability.

Cross References. Section 1318 is referred to in sections 1307, 2107 of this title.

§ 1319. Financing of energy supply alternatives.

(a) Recovery of certain additional expenses.—If:

(1) a natural gas or electric public utility elects to establish a conservation or load management program and that program is approved by the commission after a determination by the commission that the program is prudent and cost-effective; or

(2) the commission orders a natural gas or electric public utility to establish a conservation or load management program that the commission determines to be prudent and cost-effective;

the commission shall allow the public utility to recover all prudent and reasonable costs associated with the development, management, financing and operation of the program, provided that such prudent and reasonable costs shall be recovered only in accordance with appropriate accounting principles. Nothing in this section shall permit the recovery of costs in a manner prohibited by section 1315 (relating to limitation on consideration of certain costs for electric utilities). Nothing in

this section shall permit the recovery of the cost of producing, generating, transmitting, distributing or furnishing electricity or natural gas.

(b) Option for recovery.—The commission may consider allowing the recovery of those costs permitted to be recovered by subsection (a) through charges to those persons who are participants in the financing program.
(Dec. 21, 1984, P.L.1270, No.241 eff. imd.; July 10, 1986, P.L.1238, No.114, eff. imd.)

§ 1320. Fuel purchase audits by complaint.

(1) Upon complaint, the commission shall conduct an audit of an electric public utility's purchases of fuel for generating purposes. Such an audit shall examine the utility's fuel purchasing activities for the two years prior to the date of such complaint, provided that:

(i) The utility does its own testing or procures its own analysis of its fuel.

(ii) The fuel cost of the utility for the most recently completed fiscal year exceeds that of the prior fiscal year by more than 5%.

(iii) The commission has not completed and made available to the public a fuel purchase audit of the utility in the past two years.

(2) This audit, which shall be completed within one year of the date of initiation of the complaint, shall include, but not be limited to, a comparison of unit price paid for fuel for generating purposes, considering such factors as ash, sulfur content, British thermal units, transportation costs and reliability of supply.

(3) The audit shall seek to determine whether the public utility's fuel purchasing procedures are conducted in such a manner as to result in the greatest benefit to the ratepayers.

(4) The commission's audit report shall contain recommendations as to methods by which the utility's fuel purchasing procedures can be adjusted so as to result in the greatest benefit to the ratepayers.

(5) The commission shall take the audit report into consideration at the utility's next request for a rate adjustment.

(6) Upon completion and release by the commission, copies of the audit report summary shall be mailed to every person who requests a copy.
(July 10, 1986, P.L. 1238, No. 114, eff. imd.)

1986 Amendment. Act 134 added section 1320.

§ 1321. Recovery of certain employee meeting expenses.

No public utility may charge to its customers as a permissible operating expense for ratemaking purposes any portion or portions of the direct or indirect costs of meetings, conferences, seminars or other events conducted by the utility for its employees, managers or directors which portion or portions of such costs represent expenditures for activities or items unrelated to the business or civic purpose of the event, such as costs for entertainment, recreation, athletic activities, personal clothing or other personal effects.
(July 10, 1986, P.L. 1238, No. 114, eff. imd.)

1986 Amendment. Act 114 added section 1321.

§ 1322. Outages of electric generating units.

(a) General rule.—Whenever an electric generating unit, determined by the commission to be a base load unit, is out of service for more than 120 consecutive days, a utility owning a share of that unit shall not be permitted to recover, through base rates, a sliding scale of rates, or by any other means, the excess energy costs incurred to generate or purchase replacement power

occasioned by any portion of the outage which the commission determines to be unreasonable or imprudent. In making its determination under this subsection, the commission shall consider, in addition to any other relevant evidence, whether the outage could have been shortened or avoided if the unit had been properly constructed, operated or maintained.

(b) Notice of outage.—Whenever an electric generating unit, determined by the commission to be a base load unit, is out of service for 45 consecutive days, any utility owning a share of that unit shall submit to the commission and the Office of Consumer Advocate a status report on that outage. The utility shall submit subsequent status reports on the outage to the commission and the Office of Consumer Advocate at least by the 20th day of each subsequent month until the unit returns to service. If more than one utility owns a share in the electric generating unit, the commission may designate one utility to make the reports required by this subsection.

(c) Operation at less than reasonable level of generation.—Whenever the actual generation of an electric generating unit, determined by the commission to be a base load unit, is less than 50% of the unit's potential generation during any calendar year or other 12-month period specified by the commission, the commission, on its own motion or upon complaint, may initiate an investigation to determine a reasonable level of generation for that unit. In establishing rates as part of that investigation or in any subsequent proceeding, the commission shall not permit recovery of the excess energy costs incurred to generate or purchase replacement power occasioned by the failure of the unit to operate at

or above such reasonable level of generation, if such failure is determined to be unreasonable or imprudent.

(d) Procedure.—In carrying out its powers and duties under this section, the commission may hold such hearings as it deems necessary. The utility shall have the burden of proof in any proceeding under this section.

(e) Other powers and duties preserved.—This section shall not be construed to diminish the powers and duties of the commission under any other provision of law to reduce rates in the event of an outage of an electric generating unit, regardless of the duration of that outage.

(f) Definition.—As used in this section the term "excess energy costs" means the additional costs incurred to purchase or generate replacement power minus the fuel costs which would have been incurred to generate an equivalent amount of power from the affected base load unit.

(July 10, 1986, P.L. 1238, No. 114, eff. imd.)

1986 Amendment. Act 114 added section 1322.

§ 1323. Procedures for new electric generating capacity.

(a) Excess capacity costs.—Whenever a public utility claims the costs of an electric generating unit in its rates for the first time and the commission finds that the unit results in the utility having excess capacity, the commission shall disallow from the utility's rates, in the same proportion as found to be excess capacity:

(1) the return on specific unit or units of any excess generating reserve;

(2) the return on the average net original cost per megawatt of the utility's generating capacity; or

(3) the equity investment in the new unit.

In addition to the dissallowances set forth in this subsection, the commission may dissallow any other costs of the unit or units which the commission deems appropriate. For the purposes of this section, a rebuttable presumption is created that a unit or units or portion thereof shall be determined to be excess unless found to be needed to meet the utility's customer demand plus a reasonable reserve margin in the test year or the year following the test year, or, if it is a base load unit, it is also found to produce annual economic benefits which will exceed the total annual cost of the plant during the test year or within a reasonable period following the test year.

(b) Units which are out of service.—Whenever an electric generating unit, determined by the commission to be a base load unit, is first claimed in the rates of a public utility and the unit is out of service at the time that the commission makes its final decision in the case in which the unit's costs are claimed, the commission shall make either of the following adjustments:

(1) exclude from the utility's rates all costs associated with the unit; or

(2) for a period of one year from the date of the final decision, require that the utility shall guarantee at least the level of either generation or energy savings, whichever produces the rate or rates most advantageous to the ratepayer, that the utility had estimated would be produced by the unit in the first year of its operation.

An adjustment shall be made under this subsection regardless of whether or not the new base load unit had been in service during or at the end of the test year used in the proceeding.

(c) Other powers and duties preserved.—This section shall not be construed to diminish the powers and duties of the commission under any other provision of law to reduce rates because of excess capacity or any other reason, provided that, in determining whether a base load unit, which was in commercial operation for at least one year prior to the effective date of this section, results in a public utility having excess capacity, cogeneration, for which an agreement has been entered into by the public utility within three years after the in-service date of the base load unit, shall not be considered by the commission in determining the reserve margins or economic benefits resulting from the base load unit for the first five years after the date of the cogeneration agreement.

(d) Record evidence.—Any adjustments to rates made under this section shall be made on the basis of specific findings upon evidence of record, which findings shall be set forth explicitly, together with their underlying rationale, in the final order of the commission.
(July 10, 1986, P.L. 1238, No. 114, eff. imd.)

1986 Amendment. Act 114 added section 1323 and provided in section 19 of the act that section 1323 shall be applicable to all cases pending before the commission.

§ 1324. Residential telephone service rates based on duration or distance of call.

(a) Required charging method.—In addition to any other method of charging offered on an optional basis, a telecommunications utility providing local exchange telephone service to residential customers within a certified exchange area must provide service which charges, for calls originating and terminating within the same local calling area, on the basis of a flat monthiy fee for all such calls made.

(b) Options.—If the commission determines that a telecommunications utility may offer to residential customers an optional method of charging for calls originating and terminating within the same local calling area based, in whole or in part, on the duration or distance of the call, it shall also offer a rate which charges for such calls only on the basis of the number of calls made.

(c) Rate relationship.—In addition to any other requirements imposed by this title, the rates for services required or permitted pursuant to subsections (a) and (b) shall be maintained at just and reasonable levels in comparison to one another.

(d) Nonresidential rates pursuant to another section.—Nothing in this section shall preclude the commission from establishing rates for other classes of telephone service based upon another section of this title.
(July 10, 1986, P.L. 1238, No. 114, eff. imd.)

1986 Amendment. Act 114 added section 1324.

§ 1325. Local exchange service increases; limitation.

(a) General rule.—In any rate proceeding pursuant to section 1308 (relating to voluntary changes in rates), no public utility shall be granted a percentage increase in local exchange service unless that percentage increase is just and reasonable. In no event shall the public utility be granted an increase in local exchange rates which is greater than the overall average percentage increase in total intrastate revenues authorized by the commission unless the utility proves by record evidence that a greater percentage increase for local exchange service is justified based upon the cost of providing that service.

(b) Generic studies permitted.—The commission, after notice and hearing, may promulgate regulations

setting forth appropriate methods of calculating the stand-alone costs of telecommunication services.

(c) Definitions.—As used in this section the following words and phrases shall have the meanings given to them in this subsection:

"Cost of providing local exchange service." The direct cost of providing the service plus a share of the costs of the dial tone line, allocated in proportion to the stand-alone cost of each class of service which utilizes the dial tone line.

"Local exchange service." The intrastate charge for access to the telephone network plus the charge for making calls which originate and terminate within the same calling area.
(July 10, 1986, P.L. 1238, No. 114, eff. imd.)

986 Amendment. Act 114 added section 1325.

APPENDIX M

Post-Embargo Pennsylvania Ratemaking Legislation

TABLE A

SUMMARY OF POST-EMBARGO[1] PENNSYLVANIA RATE MAKING LEGISLATION

Act No.	Subject
1976-226	PUC required to order any public utility which is found to have improperly paid a sum in excess of its contract price for coal during the calendar year 1974 to refund improper excess amounts to consumers.
1982-335	(The act involved in this case.)
1984-22	Excluding from operating expenses for ratemaking any direct or indirect expense for advertising for the purpose of influencing public opinion with respect to any legislation, administrative action or candidate election or with respect to any controversial issue to be decided by public voting (§ 1316).
1984-74	Shared benefits procedure required for electric utilities and the ratepayers as an incentive to implement mandated use of coal as fuel (§ 514).
1984-123	Electric utility may include excess of actual cost over estimated cost of electric generating units costing more than $100 million only upon finding that the excess was "necessary and proper." (§ 1308(f)) (retroactive to start of construction of pending units).

[1]Pennsylvania enacted a comprehensive Public Utility Law in 1937, Act No. 1937-286. This statutory structure was sufficiently flexible that *no* subsequent amendments to Pennsylvania's fixed-service ratemaking methodology were enacted during the pre- and post-*Hope* era prior to the Arab oil embargo.

Act No.	Subject
1984-153 1984-240	Substituting prudent investment (original cost) for fair value rate base (§ 1311).
1984-241	Electric and gas public utilities may recover prudent and reasonable costs associated with conservation or load management programs (§ 1319).
1985-62	Commission may order cancellation or modification of construction of any electric generation unit; for any electric generating unit cancelled after October 10, 1985, either voluntarily or by Commission order Commission to permit return of, but not return on, prudently incurred costs of any partially completed facility when cancellation is found by the Commission to be in the public interest (§ 520).
1986-80	Commission may allow up to 50% of capital cost of uprating existing coal-fired electric generating facility as CWIP notwithstanding § 1315 (§ 514(c)). Commission may allow up to 50% of capital cost of capital additions of existing coal-fired electric generating facility as CWIP notwithstanding § 1315 if Commission has prohibited the utility from retiring the unit or has ordered it returned to normal operation (§ 521(f)).
1986-114	Governor to report annually to the General Assembly on performance of Commission, including but not limited to, a summary of all rate proceedings completed within the

Act No.	Subject
	reporting period, the amount of the rate increase requested in each such proceeding, the amount of the request granted by the commission in each such proceeding, the percentage increase in rates requested and granted in each such proceeding as compared to the percentage increase requested and granted in the most recent similar proceeding for the affected utility prior to the reporting period and other matters (§ 321). Major gas, electric and telephone utilities to use all reasonable efforts to reduce expenses (with certain exceptions) for the calendar year 1986 as compared with 1985 (§ 522). Commission shall consider, in addition to all other relevant evidence of record, the efficiency, effectiveness and adequacy of service of each utility and specified detailed considerations when determining "just and reasonable" rates (§ 523). Commission may reject, in whole or in part, a request for increased rates where Commission finds that quantity or quality of service is inadequate (§ 526). (applicable to all cases pending before the commission or the courts). Rates to the public shall reflect savings to utility from cogeneration (§ 527). All advertising expense shall be disallowed unless expense meets specified statutory criteria (§ 1316).

Act No.	Subject
	All membership fees to fraternal, social or sports clubs shall be disallowed (§ 1316.1).
	All direct or indirect costs of meetings, conferences, seminars or other events conducted by a utility for its employees, managers or directors unrelated to the business or civic purposes of the event, such as costs for entertainment, recreation, athletic activities, personal clothing or other personal effects shall be disallowed (§ 1321).
	Certain costs related to electric generating stations suffering outages shall be disallowed (§ 1322).
	Certain amounts to be disallowed from electric utility's rates upon a finding of excess capacity; if a new generating unit is out of service at time Commission decides rate case (regardless of fact that unit was operating at the end of test year) Commission must either exclude all costs of unit or require one year guarantee at estimated levels of "either generation or energy savings, whichever produces the rate or rates most advantageous to the ratepayer" (§ 1323) (applicable to all cases pending before the commission).

No. 1976-226

AN ACT

HB 2223

Mandating the Public Utility Commisson to require certain utilities to refund to consumers certain sums of moneys.

The General Assembly of the Commonwealth of Pennsylvania hereby enacts as follows:

Section 1. The Public Utility Commission is hereby required to order any public utility which is found by the commission after a hearing to have improperly paid a sum in excess of its contract price for coal during the calendar year 1974 to refund said improper excess amount to its consumers. The Public Utility Commisson shall oversee and direct the process of such refunding of the money to the consumers. The money refunded to the consumers pursuant to this act shall be paid from the equity of the stockholders of said companies.

Section 2. The commission shall adopt regulations which shall prohibit utilities subject to its jurisdiction from paying for or agreeing to pay for goods, services, equipment, or fuels at prices in excess of those contained in contracts existing between such utilities and providers of such goods, services, equipment, or fuel services.

Section 3. This act shall take effect immediately.

APPROVED—The 7th day of October, A.D. 1976.

MILTON J. SHAPP

No. 1982-335

AN ACT

SB 1366

Amending Title 66 (Public Utilities) of the Pennsylvania Consolidated Statutes, providing a limitation on the consideration of certain costs in the rate base for electric public utilities.

The General Assembly of the Commonwealth of Pennsylvania hereby enacts as follows:

Section 1. Title 66, act of November 25, 1970 (P.L.707, No.230), known as the Pennsylvania Consolidated Statutes, is amended by adding a section to read:

§ 1315. Limitation on consideration of certain costs for electric utilities.

Except for such nonrevenue producing, nonexpense reducing investments as may be reasonably shown to be necessary to improve environmental conditions at existing facilities or improve safety at existing facilities or as may be required to convert facilities to the utilization of coal, the cost of construction or expansion of a facility undertaken by a public utility producing, generating, transmitting, distributing or furnishing electricity shall not be made a part of the rate base nor otherwise included in the rates charged by the electric utility until such time as the facility is used and useful in service to the public. Except as stated in this section, no electric utility property shall be deemed used and useful until it is presently providing actual utility service to the customers.

Section 2. This act shall be applicable to all proceedings pending before the Public Utility Commission and

the courts at this time. Nothing contained in this act shall be construed to modify or change existing law with regard to rate making treatment of investment in facilities of fixed utilities other than electric utilities.

Section 3. This act shall take effect immediately.

APPROVED—The 30th day of December, A.D. 1982.

DICK THORNBURGH

No. 1984-22

AN ACT

HB 1241

Amending Title 66 (Public Utilities) of the Pennsylvania Consolidated Statutes, providing for the ownership and maintenance of gas service lines and for gas or electric utility advertising expenses and regulation.

The General Assembly of the Commonwealth of Pennsylvania hereby enacts as follows:

* * *

Section 2. Title 66 is amended by adding sections to read:

§ 1316. Recovery of advertising expenses.

(a) General rule.—For purposes of rate determinations, no gas or electric public utility may charge to its consumers as a permissible operating expense for rate-making purposes any direct or indirect expenditure by the utility for political advertising.

(b) Charging expenses to stockholders.—Any direct or indirect expenditure by a gas or electric utility for political advertising shall be charged to its stockholders and shall not be included as an operating expense for rate-making purposes.

(c) Definition.—As used in this section the term "political advertising" means any advertising for the purpose of influencing public opinion with respect to any legislative, administrative action or candidate election or with respect to any controversial issue to be decided by public voting. The term includes money spent for lobbying but not money spent for appearances before

regulatory or other governmental bodies in connection with a gas or electric public utility's existing or proposed operations.

* * *

APPROVED—The 7th day of March, A.D. 1984.

DICK THORNBURGH

No. 1984-74

AN ACT

HB 132

Amending Title 66 (Public Utilities) of the Pennsylvania consolidated Statutes, providing for commission powers and duties relating to the use of coal; prohibiting certain natural gas utilities from utilizing a sliding scale of rates to recover natural gas costs; and further providing for procedures and standards for regulating the rates of natural gas utilities.

The General Assembly of the Commonwealth of Pennsylvania hereby enacts as follows:

Section 1. Title 66 of the Pennsylvania Consolidated Statutes is amended by adding a section to read:

§ 514. Use of coal.

(a) Upgrading capability to use coal.—The commission shall require utilities to uprate their electric power production by upgrading the capability to use coal in existing coal-fueled plants where economically feasible.

(b) Incentive for uprating.—The commission shall develop a special cost recovery and shared benefits procedure for electric utilities and their ratepayers as an incentive to implement upratings as provided in subsection (a).

* * *

APPROVED—The 31st day of May, A.D. 1984.

DICK THORNBURGH

No. 1984-123

AN ACT

SB 58

Amending Title 66 (Public Utilities) of the Pennsylvania Consolidated Statutes, providing for the transportation of property of unusual value, including money and securities, in armored motor vehicles; regulating construction costs of public utilities; and limiting rate increases.

The General Assembly of the Commonwealth of Pennsylvania hereby enacts as follows:

* * *

Section 3. Section 1308 of Title 66 is amended by adding a subsection to read:

§ 1308. Voluntary changes in rates.

* * *

(f) Limitation on rate increases by certain public utilities.—Whenever there is filed with the commission any tariff stating a new rate based in whole or in part on the cost of constructing an electric generating unit, the commission shall compare the estimated construction cost filed in accordance with section 515(a) (relating to construction cost of electric generating units) with the actual construction cost submitted by the utility in support of that tariff. If the actual construction cost exceeds the estimated construction cost, the rate determined by the commission under this section shall not be based on any part of that excess unless the public utility proves that part of the excess to have been necessary and proper. In making its determination under this subsection, the commission shall consider all relevant and material evidence, including evidence obtained pursuant to sec-

tion 515. For purposes of this subsection "construction" includes any work performed on an electric generating unit which required, or is expected to require, the affected public utility to incur an aggregate of at least $100,000,000 of expenses which, in accordance with generally accepted accounting principles, are capital expenses and not operating or maintenance expenses.

* * *

Section 5. In the case of construction of an electric generating unit begun, but not completed, prior to the effective date, the affected public utility shall, within 30 days after the effective date, submit an estimate of the cost of constructing that unit which was formulated no later than 30 days from the beginning of construction. For the purposes of 66 Pa.C.S. §§ 515 and 1308(f), such estimates shall be deemed to have been filed in accordance with section 515(a). The commission shall promulgate rules and regulations to implement sections 515 and 1308(f) as added by this act.

Section 6. This act shall take effect immediately.

APPROVED—The 6th day of July, A.D. 1984.

DICK THORNBURGH

No. 1984-153

AN ACT

SB 1329

Amending Title 66 (Public Utilities) of the Pennsylvania Consolidated Statutes, prohibiting multiple filings; defining rate base; and regulating valuation.

The General Assembly of the Commonwealth of Pennsylvania hereby enacts as follows:

* * *

Section 4. Section 1311 of Title 66 is amended to read:

§ 1311. Valuation of ***and return on the*** property of a public utility.

(a) Valuation generally.—The commission may, after reasonable notice and hearing, ascertain and fix the **[fair]** value of the whole or any part of the property of any public utility, insofar as the same is material to the exercise of the jurisdiction of the commission, and may make revaluations from time to time **[and ascertain the fair value]** ***in the value of rate base of a public utility on account*** of all new construction, extensions, **[and]** additions ***and retirements*** to the property of any public utility.

(b) Method of valuation.—The value of the property of the public utility included in the rate base shall be the original cost of the property when first devoted to the public service less the applicable accrued depreciation.

(c) Segregation of property.—When any public utility furnishes more than one of the different types of utility service, the commission shall segregate the property used and useful in furnishing each type of such service, and shall not consider the property of such public utili-

ty as a unit in determining the value of the **[property]** ***rate base*** of such public utility for the purpose of fixing rates.

(d) Common carriers.—In fixing any rate of a public utility engaged exclusively as a common carrier by motor vehicle, the commission may, in lieu of other standards established by law, fix the fair return by relating the fair and reasonable operating expenses, depreciation, taxes and other costs of furnishing service to operating revenues.

Section 5. (a) The amendments to 66 Pa.C.S. §§ 102 (relating to definitions), 1307(a) (relating to sliding scale of rates; adjustments) and 1311 (relating to valuation of and return on the property of a public utility) made by this act shall take effect in 60 days.

(b) The amendment to Pa.C.S. § 1308(d.1) (relating to voluntary changes in rates) made by this act shall take effect immediately.

APPROVED—The 27th day of September, A.D. 1984.

DICK THORNBURGH

NO. 1984-240

AN ACT

SB 1196

Amending Title 66 (Public Utilities) of the Pennsylvania Consolidated Statutes, providing for rate communications to utility customers; defining "rate base"; regulating valuation; prohibiting certain natural gas utilities from utilizing a sliding scale of rates to recover natural gas costs; further providing for commission powers and duties relating to the use of coal, and for procedures and standards for regulating the rates of natural gas utilities; and making a repeal.

The General Assembly of the Commmonwealth of Pennsylvania hereby enacts as follows:

* * *

Section 6. Section 1311 of Title 66 is amended to read:

§ 1311. Valuation of ***and return on the*** property of a public utility.

(a) Valuation generally.—The commission may, after reasonable notice and hearing, ascertain and fix the **[fair]** value of the whole or any part of the property of any public utility, insofar as the same is material to the exercise of the jurisdiction of the commission, and may make revaluations from time to time **[and ascertain the fair value]** ***in the value of rate base of a public utility on account*** of all new construction, extensions, **[and]** additions ***and retirements*** to the property of any public utility.

(b) Method of valuation.—The value of the property of the public utility included in the rate base shall be the original cost of the property when first devoted to the public service less the applicable accrued depreciation as such depreciation is determined by the commission.

*(c) **Segregation of property.***—When any public utility furnishes more than one of the different types of utility service, the commission shall segregate the property used and useful in furnishing each type of such service, and shall not consider the property of such public utility as a unit in determining the value of the [**property**] ***rate base*** of such public utility for the purpose of fixing rates.

*(d) **Common carriers.***—In fixing any rate of a public utility engaged exclusively as a common carrier by motor vehicle, the commission may, in lieu of other standards established by law, fix the fair return by relating the fair and reasonable operating expenses, depreciation, taxes and other costs of furnishing service to operating revenues.

* * *

Section 9. This act shall take effect immediately.

APPROVED—The 21st day of December, A.D. 1984.

DICK THORNBURGH

No. 1984-241

AN ACT

SB 1330

Amending Title 66 (Public Utilities) of the Pennsylvania Consolidated Statutes, further defining the term "public utility"; and providing for the conversion of generating units from oil or gas to coal and for the recovery of conversion costs, for the approval of the construction of generating units fueled by nuclear energy, oil or natural gas and for the financing of energy supply alternatives.

The General Assembly of the Commonwealth of Pennsylvania hereby enacts as follows:

* * *

§ 1319. Financing of energy supply alternatives.

(a) Recovery of certain additional expenses.—If a natural gas or electric public utility elects to establish a conservation or load management program and that program is approved by the commission after a determination by the commission that the program is prudent and cost-effective, the commission shall allow the public utility to recover all prudent and reasonable costs associated with the development, management, financing and operation of the program, provided that such prudent and reasonable costs shall be recovered only in accordance with appropriate accounting principles. Nothing in this section shall permit the recovery of costs in a manner prohibited by section 1315 (relating to limitation on consideration of certain costs for electric utilities). Nothing in this section shall permit the recovery of the cost of producing, generating, transmitting, distributing or furnishing electricity or natural gas.

(b) Option for recovery.—The commission may consider allowing the recovery of those costs permitted to be recovered by subsection (a) through charges to those persons who are participants in the financing program.

* * *

Section 4. (a) The amendments adding sections 518 and 519 shall take effect in 60 days.

(b) The remainder of this act shall take effect immediately.

APPROVED—The 21st day of December, A.D. 1984.

DICK THORNBURGH

No. 1985-62

AN ACT

SB 543

Amending Title 66 (Public Utilities) of the Pennsylvania Consolidated Statutes, further defining "public utility"; further providing that the transcript of public hearings be considered part of the record in proceedings before the commission; and providing the Public Utility Commission with authority to order electric utilities to cancel or modify construction of generating units.

The General Assembly of the Commonwealth of Pennsylvania hereby enacts as follows:

* * *

Section 3. Title 66 is amended by adding a section to read:

§ 520. Power of commission to order cancellation or modification of construction of electric generating units.

(a) General rule.—The commission shall order any public utility engaged in producing, generating, transmitting, distributing or furnishing electricity to cancel or modify the construction of, or its participation in the construction of, any generating unit where the commission, after notice and an opportunity for hearing, determines that the construction is not in the public interest. In addition to any other relevant matters, the commission shall consider in its determination whether:

(1) The generating unit is necessary for the utility to provide adequate and reliable service to the public.

(2) There are less costly alternatives by which the utility could maintain its ability to provide adequate and reliable service.

(b) Investigations and hearings.—For the purpose of enabling the commission to make its determination, it may hold hearings, make inquiries and require the submission of information which it deems necessary or proper in enabling it to reach a determination. The burden of proof at these hearings to show that construction of the generating unit is in the public interest shall be on the public utility.

(c) Regulatory treatment of costs.—Notwithstanding any other provisions of this title, for a generating unit canceled after the effective date of this section, either voluntarily or by commission order, an electric utility may be permitted to recover a return of, but not a return on, prudently incurred costs on any partially completed facility when cancellation is found by the commission to be in the public interest. The burden of proof to show that any costs claimed were prudently incurred shall be on the public utility.

* * *

Section 5. (a) Sections 1, 2 and 4 of this act shall take effect in 60 days.

(b) The remainder of this act shall take effect immediately.

APPROVED—The 10th day of October, A.D. 1985.

DICK THORNBURGH

NO. 1986-80

AN ACT

HB 258

Amending Title 66 (Public Utilities) of the Pennsylvania Consolidated Statutes, adding provisions to allow limited construction work in progress for coal plants; and providing for retirement of electric generating units.

The General Assembly of the Commonwealth of Pennsylvania hereby enacts as follows:

Section 1. Section 514 of Title 66 of the Pennsylvania Consolidated Statutes is amended to read:

§ 514. Use of coal.

(a) Upgrading capability to use coal.—The commission shall promulgate regulations which require utilities to uprate their electric power production by **[upgrading]** ***increasing*** the capability to use coal in existing coal-fueled plants where economically feasible and where the uprate is beneficial to ratepayers.

(b) Incentive for uprating.—The commission shall promulgate regulations which establish a special cost recovery and shared benefits procedure for electric utilities and their ratepayers as an incentive to implement upratings as provided in subsection (a). Nothing in this section shall permit or require the commission to establish rates or procedures which are inconsistent with any other section in this title.

(c) Cost of upgrading.—Notwithstanding section 1315 (relating to limitation on consideration of certain costs for electric utilities) and subject to regulations promulgated by the commission, the commission may allow a portion of the prudently incurred costs, determined on a

per megawatt basis and not to exceed 50% of the unit's undepreciated original cost per megawatt, of uprating the capability of an existing coal-fueled plant to use coal mined in Pennsylvania to be made a part of the rate base or otherwise included in the rates charged by the utility before such uprating is completed. This subsection shall not apply unless, upon application of the affected public utility, the commission determines that the uprating would be more cost effective for the utility's ratepayers than other alternatives for meeting the utility's load and capacity requirements. Notwithstanding section 1309 (relating to rates fixed on complaint; investigation of costs of production), the commission, by regulation, shall provide for a utility to remove the costs of an uprating from its rate base and to refund any revenues collected as the result of this subsection, plus interest, which shall be the average rate of interest specified for residential mortgage lending by the Secretary of Banking in accordance with the act of January 30, 1974 (P.L. 13, No. 6), referred to as the Loan Interest and Protection Law, during the period or periods for which the commission orders refunds, if the commission, after notice and hearings, determines that the uprating has not been completed within a reasonable time.

Section 2. Section 517(e) of Title 66 is repealed.

Section 3. Title 66 is amended by adding a section to read:

§ 521. Retirement of electric generating units.

(a) Removal from normal operation.—No public utility shall discontinue an electric generating unit from normal operation unless it has petitioned for and obtained the approval of the commission. The commission may, upon its own motion or upon complaint, prohibit a public

utility from discontinuing an electric generating unit from normal operation if the commission determines that it would be more cost effective for the utility's ratepayers if the unit were to remain in normal operation, either with or without capital additions or operating improvements, than if the utility were to implement its plan for replacing the power which the unit is, or could be made, capable of producing.

(b) Return to normal operation.—The commission may, upon its own motion or upon complaint, order a public utility to return an electric generating unit to normal operation if the commission determines that it would be more cost effective for the utility's ratepayers if the unit were to be returned to normal operation, with or without capital additions or operating improvements, than if the utility were to implement its plan for providing the power which the unit is, or could be made, capable of producing.

(c) Procedure.—The commission may hold such hearings as it deems necessary in making the determinations required by subsection (a) or (b). The affected public utility shall have the burden of proof in any proceeding pursuant to this section.

(d) Regulations.—The commission may adopt such regulations as it deems necessary to carry out its powers and duties under this section.

(e) Exclusion.—This section shall not apply to a nuclear generating unit or to variations in operation of electric generating units to satisfy economic dispatch requirements or to maintain intrasystem or intersystem stability.

(f) Construction costs.—Notwithstanding section 1315 (relating to limitation on consideration of certain costs

for electric utilities) and subject to regulations promulgated by the commission, the commission may allow a portion of the prudently incurred costs of capital additions, determined on a per megawatt basis and not to exceed 50% of the unit's undepreciated original cost per magawatt, to an electric generating unit to be made a part of the rate base or otherwise included in the rates charged by the utility before such capital additions are completed if the commission, acting pursuant to subsection (a) or (b), prohibits the utility from retiring the unit or orders the utility to return the unit to normal operation, provided that:

(1) the capital additions would allow the continued or increased use of coal mined in Pennsylvania; and

(2) the capital additions would be more cost effective for the utility's ratepayers than other alternatives for meeting the utility's load and capacity requirements.

Notwithstanding section 1309 (relating to rates fixed on complaint; investigation of costs of production), the commission, by regulation, shall provide for a utility to remove the costs of capital additions from its rate base and to refund any revenues collected as the result of this subsection, plus interest, which shall be the average rate of interest specified for residential mortgage lending by the Secretary of Banking in accordance with the act of January 30, 1974 (P.L.13, No.6), referred to as the Loan Interest and Protection Law, during the period or periods for which the commission orders refunds, if the commission, after notice and hearing, determines that the capital addition has not been completed within a reasonable time.

(g) Definition.—As used in this section the term "normal operation" means the continuing availability of an electric generating unit to meet consumer demand except during:

(1) Scheduled outages for repairs, tests or other procedures essential to the unit's further use.

(2) Unscheduled outages caused by the unit's physical malfunctioning or breakdown.

(3) Reduced levels of generation pending execution of repairs.

(4) Reduced levels or complete cessation of generation, on a temporary basis, because of disruptions in fuel supplies, waste disposal or cooling water; or because of compliance with environmental protection limitations or conservation of fuel during periods of, or in anticipation of, scarcity.

Section 4. This act shall take effect in 60 days.

APPROVED—The 3rd day of July, A. D. 1986.

DICK THORNBURGH

No. 1986-114

AN ACT

HB 1639

Amending Title 66 (Public Utilities) of the Pennsylvania Consolidated Statutes, further providing for the appointment, terms, compensation and qualifications of and restrictions on commissioners; providing for a director of operations, the Office of Trial Staff, the Office of Special Assistants and the Director of Operations and their powers and duties; further providing for procedures, reports, budget requests and audits and for rate increase requests; providing for management efficiency investigators and for fuel purchase audits; limiting recovery of certain employee meeting expenses; making provisions relating to the sale of electric generating units; providing for the regulation of excess capacity costs and new electric generating units; restricting rate setting procedures of telephone companies; requiring that certain data be supplied by electric utilities; further regulating the recovery of advertising expenses and the recovery of club dues; authorizing the commission to order conservation and load management; regulating coin telephone service; and reestablishing the Pennsylvania Public Utility Commission.

The General Assembly of the Commonwealth of Pennsylvania hereby enacts as follows:

* * *

Section 2. Title 66 is amended by adding a section to read:

§ 321. Annual reports.

The commission shall annually transmit, to the Governor and the General Assembly and shall make available to the public, a report on the conduct of the commission. The report shall include, but shall not be limited to, a summary of all rate proceedings completed within the reporting period, the amount of the rate increase

requested in each such proceeding, the amount of the request granted by the commission in each such proceeding, the percentage increase in rates requested and granted in each such proceeding as compared to the percentage increase requested and granted in the most recent similar proceeding for the affected utility prior to the reporting period, a summary of other significant regulatory issues which the commission resolved during the reporting period, a summary of significant orders and decisions of the commission and the courts of the Commonwealth during the reporting period relating to public utilities, a summary of significant anticipated issues by type of utility and a status report of any commission action regarding these issues, and a summary of the audits completed by the commission during the reporting period. In the annual report and at such other times as the commission determines, the commission shall make recommendations to the Governor and the General Assembly which the commission believes to be necessary or desirable to protect the public interest.

* * *

Section 5. Title 66 is amended by adding sections to read:

§ 522. Expense reduction program.

(a) Target.—The commission shall establish an expense reduction program for calendar year 1986 for all electric and gas utilities with total annual intrastate operating revenues of at least $40,000,000 and for all telephone utilities with total annual intrastate operating revenues of at least $9,000,000. Utilities regulated by the commission pursuant to this subsection shall make every reasonable effort to reduce their level of expenses, other than expenses associated with depreciation, fuel, collec-

tive bargaining agreements and other categories of expense as determined by the commission for the calender year 1986 as compared to the calender year 1985. The commission shall periodically review the expense reducing efforts undertaken by utilities pursuant to this subsection and shall take appropriate action in response to these efforts.

(b) Ongoing effort.—The commission may direct or permit any utility to take any lawful action not inconsistent with this title for the purpose of encouraging economies, efficiencies or improvements which benefit the utility and its ratepayers.

§ 523. Performance factor consideration.

(a) Considerations.—The commission shall consider, in addition to all other relevant evidence of record, the efficiency, effectiveness and adequacy of service of each utility when determining just and reasonable rates under this title. On the basis of the commission's consideration of such evidence, it shall give effect to this section by making such adjustments to specific components of the utility's claimed cost of service as it may determine to be proper and appropriate. Any adjustment made under this section shall be made on the basis of specific findings upon evidence of record, which findings shall be set forth explicitly, together with their underlying rationale, in the final order of the commission.

(b) Fixed utilities.—As part of its duties pursuant to subsection (a), the commission shall set forth criteria by which it will evaluate future fixed utility performance and in assessing the performance of a fixed utility pursuant to subsection (a), the commission shall consider specifically the following:

(1) Management effectiveness and operating efficiency as measured by an audit pursuant to section

516 (relaiting to audits of certain utilities) to the extent that the audit or portions of the audit have been properly introduced by a party into the record of the proceeding in accordance with applicable rules of evidence and procedure.

(2) Action or failure to act pursuant to section 514 (relating to use of coal) to upgrade capability to use coal for electric utilities.

(3) Efficiency and cost-effectiveness of generating capacity for electric utilities.

(4) Action or failure to act to encourage development of cost-effective energy supply alternatives such as conservation or load management, cogeneration or small power production for electric and gas utilities.

(5) Action or failure to act to encourage cost-effective conservation by customers of water utilities.

(6) Action or failure to act to contain costs of constructing new generating units consistent with sections 515 (relating to construction cost of electric generating units) and 1308(f) (relating to voluntary changes in rates).

(7) Any other relevant and material evidence of efficiency, effectiveness and adequacy of service.

* * *

§ 526. Rejection of rate increase requests due to inadequate quality or quantity of service.

(a) General rule.—The commission may reject, in whole or in part, a public utility's request to increase its rates where the commission concludes, after hearing,

that the service rendered by the public utility is inadequate in that it fails to meet quantity or quality [sic] for the type of service provided.

(b) Other powers and duties preserved.—This section shall not be construed to diminish the powers and duties of the commission under any other provision of law to remedy inadequate service by a public utility.

§ 527. Cogeneration rules and regulations.

The commission shall promulgate rules and regulations concerning the rates, terms, conditions and availability of cogeneration in this Commonwealth. The commission shall require that utility rates to the public reflect savings to the utility from cogeneration.

Section 6. Section 1316 of Title 66 is amended to read:

§ 1316. Recovery of advertising expenses.

(a) General rule—For purposes of rate determinations, no [**gas or electric**] public utility may charge to its consumers as a permissible operating expense for ratemaking purposes any direct or indirect expenditure by the utility for political advertising. ***The commission shall also disallow as operating expense for ratemaking purposes expenditures for other advertising, unless and only to the extent that the commission finds that such advertising is reasonable and meets one or more of the following criteria:***

(1) Is required by law or regulation.

(2) Is in support of the issuance, marketing or acquisition of securities or other forms of financing.

(3) Encourages energy independence by promoting the wise development and use of domestic

sources of coal, oil or natural gas and does not promote one method of generating electricity as preferable to other methods of generating electricity.

(4) Provides important information to the public regarding safety, rate changes, means of reducing usage or bills, load management or energy conservation.

(5) Provides a direct benefit to ratepayers.

(6) Is for the promotion of community service or economic development.

(b) Charging expenses to stockholders.—Any direct or indirect expenditure by a [**gas or electric utility**] ***public utility*** for political advertising, ***or any other advertising not meeting the criteria set forth in subsection (a),*** shall be charged to its stockholders and shall not be included as an operating expense for ratemaking purposes.

(c) Filing of information and materials.—Whenever a public utility proposes a change in rates under section 1308 (relating to voluntary changes in rates), the public utility shall file with the commission a listing of each type of advertising prepared, distributed or presented by the public utility or to be prepared, distributed or presented by the public utility during the test year utilized by the public utility in discharging its burden of proof, and a listing of each type of advertising prepared, distributed or presented by the public utility during the year immediately preceding the test year, as well as an accounting of the expenditures by the public utility for such advertising, to the extent such advertising is proposed to be included as operating expense for ratemaking purposes. The filing requirements imposed by this subsection shall not be construed to limit the right of any party to discovery under this or any other provision of law.

[(c)] *(d)* Definition.—As used in this section the term "political advertising" means any advertising for the purpose of influencing public opinion with respect to any legislative, administrative action or candidate election or with respect to any controversial issue to be decided by public voting. The term includes money spent for lobbying but not money spent for appearances before regulatory or other governmental bodies in connection with a **[gas or electric]** public utility's existing or proposed operations.

Section 7. Title 66 is amended by adding a section to read:

§ 1316.1. Recovery of club dues.

No public utility may charge to its customers as a permissible operating expense for ratemaking purposes membership fees, dues or charges to fraternal, social or sports clubs or organizations.

* * *

§ 1321. Recovery of certain employee meeting expenses.

No public utility may charge to its customers as a permissible operating expense for ratemaking purposes any portion or portions of the direct or indirect costs of meetings, conferences, seminars or other events conducted by the utility for its employees, managers or directors which portion or portions of such costs represent expenditures for activities or items unrelated to the business or civic purpose of the event, such as costs for entertainment, recreation, athletic activities, personal clothing or other personal effects.

§ 1322. Outages of electric generating units.

(a) General rule.—Whenever an electric generating unit, determined by the commission to be a base load

unit, is out of service for more than 120 consecutive days, a utility owning a share of that unit shall not be permitted to recover, through base rates, a sliding scale of rates, or by any other means, the excess energy costs incurred to generate or purchase replacement power occasioned by any portion of the outage which the commission determines to be unreasonable or imprudent. In making its determination under this subsection, the commission shall consider, in addition to any other relevant evidence, whether the outage could have been shortened or avoided if the unit had been properly constructed, operated or maintained.

(b) Notice of outage.—Whenever an electric generating unit, determined by the commission to be a base load unit, is out of service for 45 consecutive days, any utility owning a share of that unit shall submit to the commission and the Office of Consumer Advocate a status report on that outage. The utility shall submit subsequent status reports on the outage to the commission and the Office of Consumer Advocate at least by the 20th day of each subsequent month until the unit returns to service. If more than one utility owns a share in the electric generating unit, the commission may designate one utility to make the reports required by this subsection.

(c) Operation at less than reasonable level of generation.—Whenever the actual generation of an electric generating unit, determined by the commission to be a base load unit, is less than 50% of the unit's potential generation during any calendar year or other 12-month period specified by the commission, the commission, on its own motion or upon complaint, may initiate an investigation to determine a reasonable level of generation for that unit. In establishing rates as part of that investigation or in any subsequent proceeding, the com-

mission shall not permit recovery of the excess energy costs incurred to generate or purchase replacement power occasioned by the failure of the unit to operate at or above such reasonable level of generation, if such failure is determined to be unreasonable or imprudent.

(d) Procedure.—In carrying out its powers and duties under this section, the commission may hold such hearings as it deems necessary. The utility shall have the burden of proof in any proceeding under this section.

(e) Other powers and duties preserved.—This section shall not be construed to diminish the powers and duties of the commission under any other provision of law to reduce rates in the event of an outage of an electric generating unit, regardless of the duration of that outage.

(f) Definition.—As used in this section the term "excess energy costs" means the additional costs incurred to purchase or generate replacement power minus the fuel costs which would have been incurred to generate an equivalent amount of power from the affected base load unit.

§ 1323. Procedures for new electric generating capacity.

(a) Excess capacity costs.—Whenever a public utility claims the costs of an electric generating unit in its rates for the first time and the commission finds that the unit results in the utility having excess capacity, the commission shall disallow from the utility's rates, in the same proportion as found to be excess capacity:

(1) the return on specific unit or units of any excess generating reserve;

(2) the return on the average net original cost per megawatt of the utility's generating capcity; or

(3) the equity investment in the new unit.

In addition to the disallowances set forth in this subsection, the commisson may disallow any other costs of the unit or units which the commission deems appropriate. For the purposes of this section, a rebuttable presumption is created that a unit or units or portion therof shall be determined to be excess unless found to be needed to meet the utility's customer demand plus a reasonable reserve margin in the test year or the year following the test year, or, if it is a base load unit, it is also found to produce annual economic benefits which will exceed the total annual cost of the plant during the test year or within a reasonable period following the test year.

(b) Units which are out of service.—Whenever an electric generating unit, determined by the commission to be a base load unit, is first claimed in the rates of a public utility and the unit is out of service at the time that the commission makes its final decision in the case in which the unit's costs are claimed, the commission shall make either of the following adjustments:

(1) exclude from the utility's rates all costs associated with the unit; or

(2) for a period of one year from the date of the final decision, require that the utility shall guarantee at least the level of either generation or energy savings, whichever produces the rate or rates most advantageous to the ratepayer, that the utility had estimated would be produced by the unit in the first year of its operation.

An adjustment shall be made under this subsection regardless of whether or not the new base load unit had been in service during or at the end of the test year used in the proceeding.

(c) Other powers and duties preserved.—This section shall not be construed to diminish the powers and duties of the commission under any other provision of law to reduce rates because of excess capacity or any other reason, provided that, in determining whether a base load unit, which was in commercial operation for at least one year prior to the effective date of this section, results in a public utility having excess capacity, cogeneration, for which an agreement has been entered into by the public utility within three years after the in-service date of the base load unit, shall not be considered by the commission in determining the reserve margins or economic benefits resulting from the base load unit for the first five years after the date of the cogeneration agreement.

(d) Record evidence.—Any adjustments to rates made under this section shall be made on the basis of specific findings upon evidence of record, which findings shall be set forth explicitly, together with their underlying rationale, in the final order of the commission.

* * *

Section 18. 66 Pa.C.S. § 526 (relating to rejection of rate increase requests due to inadequate quality or quantity of service) shall be applicable to all cases pending before the commission or courts, whether on appeal or otherwise.

Section 19. 66 Pa.C.S. § 1323 (relating to procedures for new electric generating capacity) shall be applicable to all cases pending before the commission.

Section 20. (a) The amendments to sections 305(a), 306 and 308(a), (b), (e) and (g) of Title 66 shall take effect in 60 days.

(b) The remainder of this act shall take effect immediately.

APPROVED—The 10th day of July, A.D. 1986.

DICK THORNBURGH

(3)

Supreme Court, U.S.
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NO. 87-1160

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1987

DUQUESNE LIGHT COMPANY
and
PENNSYLVANIA POWER COMPANY,
Appellants

v.

DAVID M. BARASCH,
CONSUMER ADVOCATE, et al.
Appellees

On Appeal From The Supreme Court Of Pennsylvania

MOTION OF APPELLEE, DAVID M. BARASCH, CONSUMER ADVOCATE, TO DISMISS OR AFFIRM

Irwin A. Popowsky*
Daniel Clearfield
Pamela Bishop Sarvey
Assistant Consumer Advocates

Attorneys for Appellee,
David M. Barasch
Consumer Advocate

Office of Attorney General
Office of Consumer Advocate
1425 Strawberry Square
Harrisburg, PA 17120
(717) 783-5048

February 11, 1988 *Counsel of Record

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MOTION OF DAVID M. BARASCH, CONSUMER ADVOCATE, TO DISMISS APPEAL, OR, IN THE ALTERNATIVE, MOTION TO AFFIRM

Pursuant to Supreme Court Rule 16.1, Appellee David M. Barasch, Consumer Advocate (hereinafter, Office of Consumer Advocate or OCA)*, hereby moves that this Honorable Court dismiss the appeal of Duquesne Light Company and Pennsylvania Power Company, on the ground that the appeal does not present a substantial federal question. In the alternative, the OCA moves that the Court affirm the decision of the Supreme Court of Pennsylvania rendered below.

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*The OCA is an agency of the Commonwealth of Pennsylvania authorized to represent the interests of Pennsylvania utility consumers before the Pennsylvania Public Utility Commission and other state and federal agencies and courts which regulate the activities of Pennsylvania's public utilities. 71 Pa. Stat. Ann. §309-1 et seq. (Purdon Supp. 1987). Appellee, David M. Barasch, has served as the Consumer Advocate of Pennsylvania since 1984.

COUNTERSTATEMENT OF THE CASE

This is an appeal by two electric utilities from a Pennsylvania Supreme Court Order which found that the Pennsylvania Public Utility Commission (hereinafter, PUC or Commission) had erred as a matter of law by requiring ratepayers to bear the costs of four power plants which were abandoned prior to construction and which therefore never provided service to those ratepayers.

In two general rate increase proceedings before the PUC, the utilities involved, Duquesne Light Company (hereinafter Duquesne) and Pennsylvania Power Company (hereinafter Penn Power), requested and received the right to recover from ratepayers, over a ten-year period, all money invested by the utilities in the abandoned projects. These rate allowances were

appealed by the OCA, but were initially upheld by a 4-3 vote of the Commonwealth Court of Pennsylvania.

The Commonwealth Court Order was reversed by the Pennsylvania Supreme Court, which unanimously ruled in an Opinion by Chief Justice Nix that the PUC Order violated the Pennsylvania Public Utility Code. Specifically, the Supreme Court agreed with the OCA's position that the allowance of rate recovery of the cost of a cancelled power plant violated Section 1315 of the Public Utility Code, 66 Pa. Cons. Stat. §1315. That provision states, with certain exceptions not pertinent here, that:

> the cost of construction or expansion of a facility undertaken by a public utility producing, generating, transmitting, distributing or furnishing electricity shall not be made a part of the rate base nor otherwise included in the rates charged by the electric utility until such time

> as the facility is used and useful in service to the public.

Section 1315 further states that:

> Except as stated in this section, no electric utility property shall be deemed used and useful until it is presently providing actual utility service to the customers.

Because there was no dispute that the abandoned plants at issue never have and never will provide actual service to customers, the Supreme Court agreed with the OCA's position that, as a matter of state law, the costs of those plants could not be charged to ratepayers. The Court also noted that this interpretation of Section 1315 was consistent with "the fundamental principles of this state's public-utility jurisprudence", i.e., that "no utility of any type is permitted, without express and valid legislative authorization, to charge ratepayers for property which is not used and useful in the production of

current utility service." 532 A.2d 325, 338 (App. 28a-29a).

The Supreme Court remanded the matter to the Commission for proceedings consistent with its Opinion. Duquesne and Penn Power then took the present appeal to this Court.

Before addressing the Companies' arguments, certain factual points should be noted.

First, as stated by Duquesne and Penn Power in their Jurisdictional Statement at 4, the four plants at issue here were cancelled prior to the issuance of a construction permit by the Nuclear Regulatory Commission. Thus, only "pre-construction" expenditures for such items as engineering and siting analyses are at issue here. Id.

For Duquesne, the total costs of the projects amounted to $34,697,389. (App.

37c). The annual expense allowance permitted for the ten-year amortization of this amount was $3,469,739. Id. This allowance was a relatively small component of an overall rate increase of $105,850,000, which brought Duquesne's total annual revenue allowance from its Pennsylvania jurisdictional ratepayers to $802,463,063. (App. 126c).

Penn Power's share of the costs in question amounted to $9,569,665, with the annual amortization allowance equal to $956,967. (App. 81e-82e). This allowance was part of a $15,364,000 rate increase, which raised Penn Power's annual allowed revenues to $184,186,000. (App. 3e-4e).

Finally, it should be noted that the majority of the ownership in these four abandoned units was held by three Ohio utilities. As in Pennsylvania, the Ohio

Public Utilities Commission initially permitted the recovery of the costs of these units from ratepayers, but that allowance was overturned as violative of state law by the Ohio Supreme Court. Office of Consumers' Counsel v. Public Utilities Commission, 67 Ohio St. 2d 153, 423 N.E.2d 820 (1981). The appeal of Cleveland Electric Illuminating Company (CEI) from that Ohio Supreme Court decision -- as well as CEI's subsequent appeals from two related orders regarding this same issue -- were summarily dismissed by this Court at 455 U.S. 914 (1982), 459 U.S. 1094 (1983), and 464 U.S. 802 (1983).

As set forth in the following Argument, the OCA respectfully submits that the appeal of Duquesne and Penn Power regarding this identical issue in the present case should be summarily dismissed as well.

ARGUMENT

I. The Arguments Raised In This Case Have Been Summarily Rejected By This Court.

As noted by the Appellants at page 13, note 13, of their Jurisdictional Statement, this is not the first case in which this Court has been asked to review state rate orders which denied recovery of the cost of cancelled power plants. Indeed, three of the four appeals cited by Appellants involved the very same plants at issue here, the difference being that the prior cases involved Ohio law, while the present case was decided under Pennsylania law.

In each of the cases noted by Appellants, the highest state court found that the recovery of cancelled plant costs was violative of state public utility law. See Northern Indiana Public Service Co. v. Citizen's Action Coalition of Indiana, Inc., 485

N.E.2d 610 (Ind. 1985), appeal dismissed and cert. denied, 106 S.Ct 2239 (1986); Cleveland Electric Illuminating Co. v. Public Utilities Commission, 4 Ohio St. 3d 107, 447 N.E.2d 746, appeal dismissed, 464 U.S. 802 (1983); Cleveland Electric Illuminating Co. v. Public Utilities Commission, No. 82-165 (Ohio, July 7, 1982), appeal dismissed, 459 U.S. 1094 (1983); Office of Consumers' Counsel v. Public Utilities Commission, 67 Ohio St. 2d 153, 423 N.E.2d 820 (1981), appeal dismissed sub nom. Cleveland Electric Illuminating Co. v. Office of Consumers' Counsel, 455 U.S. 914 (1982). The utilities in each of those cases appealed to this Court on the ground that the denial of such costs represented an unconstitutional confiscation of their property. Each of those appeals was summarily rejected by

this Court either for lack of jurisdiction, lack of a properly presented federal question, or -- in the Cleveland Electric Illuminating appeal at 464 U.S. 802 -- for want of a substantial federal question. A dismissal for want of a substantial federal question is, of course, a decision on the merits. See Meek v. Pittenger, 421 U.S. 349, 367 n.16 (1975).

The Appellants attempt to distinguish the Cleveland Electric Illuminating dismissal on several grounds, including the obvious fact that the case did not involve Pennsylvania law. Jurisdictional Statement at 13 n.13. The OCA would note, however, that, on the same day that this Court disposed of the above-cited appeal of Northern Indiana Public Service Company, the Court also dismissed, for want of a

substantial federal question, the appeal of two Pennsylvania electric utilities who challenged the denial of cost recovery on their investment in the Three Mile Island Unit 1 nuclear power plant. That plant was not abandoned, but was out of service for a prolonged period due to an accident at the adjacent Three Mile Island Unit 2. Pennsylvania Electric Co. v. Pennsylvania Public Utility Comm'n, 509 Pa. 324, 502 A.2d 130 (1985), appeal dismissed sub nom. Metropolitan Edison Co. v. Pennsylvania Public Utility Commission, 106 S.Ct. 2239 (1986).

In the Pennsylvania Electric case, supra, the Pennsylvania Supreme Court relied on established principles of Pennsylvania law to find that the utilities had no right to charge ratepayers for the costs of a unit which was not "used and useful" in service to

the public. Moreover, the Pennsylvania Supreme Court ruled that the used and useful principle was not "overridden" by this Court's decision in FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944), and that the investor interests discussed in the Hope case are not "of constitutional dimension, but are among the factors to be taken into account in the balancing of interests process." 509 Pa. at 334, 502 A.2d at 135-36. The utilities appealed that case to this Court, specifically raising the question of whether the Pennsylvania Supreme Court erred by finding that the investor interests in Hope were not of "constitutional dimension." No. 85-1493, October Term 1985, Jurisdictional Statement at i. The OCA and the Pennsylvania PUC moved to dismiss the utilities' appeal and, on May 27, 1986, the appeal was

dismissed by this Court for want of a substantial federal question. See also Jersey Central Power & Light Co. v. Board of Public Utilities, 466 U.S. 947 (1984), in which the parallel appeal of the New Jersey utility which owns a share of Three Mile Island was also dismissed for want of a substantial federal question.

The OCA recognizes that, as noted by Appellants here, this Court has stated that "although summary dispositions are decisions on the merits, the decisions extend only to 'the precise issues presented and necessarily decided by those actions.'" Metromedia, Inc. v. City of San Diego, 453 U.S. 490, 499 (1981), quoting, Mandel v. Bradley, 432 U.S. 173, 176 (1977). The OCA submits, however, that, in the Cleveland Electric Illuminating case reported at 464 U.S. 802 (1983), this Court "necessarily

decided" that the denial of rate recovery of the Ohio utilities' share of the plants at issue in this case was not confiscatory in violation of the United States Constitution. In addition, in the Pennsylvania Electric case reported at 106 S.Ct. 2239, this Court "necessarily decided" that the Pennsylvania Supreme Court's strict application of the used and useful principle was not constitutionally defective under the standards established by this Court in FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944). Thus, the questions raised in the present appeal already have been decided by this Court.

Nevertheless, the OCA also recognizes that this Court has stated that "[i]t is not at all unusual for the Court to find it appropriate to give

full consideration to a question that has been the subject of previous summary action." Washington v. Yakima Indian Nation, 439 U.S. 463, 477 n.20 (1979).

While this Court thus may choose to examine the constitutionality of the Pennsylvania Supreme Court's refusal to permit recovery of cancelled plant costs -- even though the Court already rejected the appeals from the Ohio Supreme Court's refusal to permit recovery of costs on the same plants -- the OCA respectfully submits that this case represents a particularly poor choice for plenary review by this Court.

As set forth more fully below, the Appellants in this case are asking this Court to return to an era of judicial review where the minutiae of each state rate decision were separately judged for their constitutional validity. Rather

than calling for the clarification of this Court's decision in Hope, the Appellants here are therefore asking the Court to ignore the fundamental teachings of that case. The Appellants are also asking this Court to substitute its views of proper economic policy for those of the state legislature, a role which this Court has eschewed for decades.

II. The Appellants' Constitutional Challenges To The Pennsylvania Supreme Court Order Are Wholly Without Merit.

A. The Used And Useful Principle, As Applied By The Pennsylvania Supreme Court In This Case, Is Consistent With The Constitutional Protections For Utility Investors Recognized By This Court.

As can be seen by a review of the Pennsylvania Supreme Court decision, the primary issue before that Court revolved around the proper interpretation of state public utility law. Specifically, the Court unanimously agreed with the OCA that Section 1315 of the Pennsylvania Public Utility Code, 66 Pa. Cons. Stat. §1315, precluded the recovery from ratepayers of the costs expended on four power plants that were cancelled in their preliminary plannning stages and thus never provided service to ratepayers. (App 15a). As noted by the Court, Section 1315 specifically states

that the costs of an electric utility facility "shall not be made a part of the rate base nor otherwise included in the rates charged by the electric utility until such time as the facility is used and useful in service to the public." The statutory provision goes on to define the "used and useful" phrase by declaring that "no electric utility property shall be deemed used and useful until it is presently providing actual utility service to the customers."*

Faced with this statutory language, as well as the undisputed fact that the facilities in question are not now providing, and indeed never will

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* Section 1315, which was added to the Pennsylvania Public Utility Code by the Pennsylvania General Assembly's Act 335 of 1982, is reprinted in its entirety at pages 231-241 of the Appellants' Appendix.

provide, actual utility service to the customers, the Court stated:

> We therefore hold that section 1315 of the Code must be read as prohibiting an electric utility from recovering the costs of cancelled plants from ratepayers, either by making such costs part of the rate base or by converting them into operating expenses through amortization.

532 A.2d at 332 (App. 15a).

Moreover, the Court went on to note that this interpretation of Section 1315 was totally consistent with "the fundamental principles of this state's public-utility jurisprudence." Id. at 338 (App. 28a). Specifically, the Court declared:

> [I]t should be clear that no utility of any type is permitted, without express and valid legislative authorization, to charge ratepayers for property which is not used and useful in the production of current utility service.

Id. (App. 28a-29a).

Appellants here obviously cannot challenge the Pennsylvania Supreme Court's interpretation of Pennsylvania state law. Appellants do claim, however, that this application of Pennsylvania law results in an unconstitutional taking of their investment in these cancelled plants.

This claim is wholly without merit.

To the extent that utility investors have a constitutional right to recovery of costs on any specific investment, the limits of such a right were set forth by this Court 50 years ago in the case of Denver Union Stock Yard Co. v. United States, 304 U.S. 470 (1938). There, the Court held:

> As of right safeguarded by the due process clause of the Fifth Amendment, appellant is entitled to rates, not per se excessive and extortionate, sufficient to yield a reasonable rate of return upon the value of property used, at the time it is being used, to render the services. But it is not

> entitled to have included any property not used and useful for that purpose.

304 U.S. at 475 (citations omitted; emphasis added).

This fundamental holding of the Denver Union Stock Yard case was based on an unbroken series of Supreme Court decisions which addressed this issue, starting with Smyth v. Ames, 169 U.S. 466, 546-47 (1898), and continuing through such cases as San Diego Land and Town Co. v. National City, 174 U.S. 739, 757-758 (1899), San Diego Land and Town Co. v. Jasper, 189 U.S. 439, 446-467 (1903), Willcox v. Consolidated Gas Co., 212 U.S. 19, 41 (1909), Minnesota Rate Cases, 230 U.S. 352, 434, 454 (1913), Los Angeles Gas & Electric Co. v. Railroad Commission, 289 U.S. 287, 305-06, 311, 316-317 (1933), Columbus Gas & Fuel Co. v. Public Utility

Commission, 292 U.S. 398, 406-407 (1934), and St. Joseph Stock Yards Co. v. United States, 11 F. Supp. 322, 329 (W.D. Mo. 1935), aff'd, 298 U.S. 38 (1936).

Nor is the continued application of the used and useful principle somehow limited to public utility law of Pennsylvania. As noted in one recent opinion of the United States Court of Appeals for the District of Columbia:

> Although methods for determining values of rate base items have evolved since Smyth v. Ames, the precept endures that an item may be included in a rate base only when it is "used and useful" in providing service. In other words, current rate payers should bear only legitimate costs of providing service to them.

Natural Gas Pipeline Co. v. FERC, 765 F.2d 1155, 1157 (D.C. Cir. 1985), cert. denied, 106 S.Ct. 794 (1986), quoting Tennessee Gas Pipeline Co. v. FERC, 606 F.2d 1094, 1109 (D.C. Cir.

1979), cert. denied, 445 U.S. 920 and 447 U.S. 922 (1980). Another recent D.C. Circuit opinion recognized that the used and useful principle "has stood as a bedrock principle of utility rate regulation" for "nearly a century." Kentucky Utilities Co. v. FERC, 760 F.2d 1321, 1324 n.4 (D.C. Cir. 1985).

While the used and useful principle typically is applied to cases involving the "rate base" or the investment on which the utility may charge a return, it is also applicable to questions involving the return of capital in investments which do not serve ratepayers.

Thus, for example, in the recent D.C. Circuit Natural Gas Pipeline case noted above, the Court upheld the Federal Energy Regulatory Commission's denial of the recovery of the pipeline company's investment in three

unsuccessful gas supply projects. 765 F.2d at 1156. Even though the utility did not seek to earn a return on this investment, the Court affirmed FERC's denial of recovery of the costs, based on FERC's rationale that "the expenditures were not used and useful to ratepayers." Id. at 1158.

Similarly, in the present case, the Pennsylvania Supreme Court recognized that the utilities could not recover their investments in non-used and useful facilities simply by "converting them into operating expenses through amortization." 532 A.2d at 332. (App. 15a). This interpretation is, of course, consistent with the express language of the section of the Pennsylvania Public Utility Code at issue, which states that the costs of non-used and useful facilities "shall not be made a part of the

rate base nor otherwise included in the rates charged by the electric utility."

While as a matter of ratemaking policy, a number of regulatory jurisdictions have determined that the costs of abandoned plants may be recovered from ratepayers, utilities have no constitutional right to a return on or a return of investment in plant which is not used and useful to ratepayers.*

The sole issue remaining, therefore, is whether this Court's decision in FPC v. Hope Natural Gas Co., 320 U.S. 591

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* It should be noted that a number of cases have called into question the issue of whether the application of the used and useful principle is constitutionally required. See Jersey Central Power & Light Co. v. FERC, 810 F.2d 1168, 1175 (D.C. Cir. 1987), Washington Gas Light Co. v. Baker, 188 F.2d 11 (D.C. Cir. 1950), cert. denied, 340 U.S. 952 (1951). In this appeal, however, the issue is whether the application of this principle is constitutionally permissible.

(1944), recognized some additional constitutional right for utility investors over and above a right to charge ratepayers for the cost of used and useful assets.

As set forth in the following section of this Argument, it is OCA's position that the Hope decision does not support such an expansion of utility investor rights. Moreover, even if such an interpretation of Hope were valid in certain cases, the present case certainly isn't one of them.

B. The Appellants' Argument Is Not Supported By The Decision Of This Court In FPC v. Hope Natural Gas Co.

The thrust of the Appellants' argument here is that the Pennsylvania Supreme Court's interpretations of the state Public Utility Code and the used and useful principle violate the United States Constitution "by precluding the

state ratemaking agency from considering constitutionally pertinent factors." Jurisdictional Statement at i. These "constitutionally pertinent factors" are purportedly distilled from this Court's decision in FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944).

In making this argument, the Appellants disregard the fundamental teaching of this Court's decision in Hope.

If the Hope case stands for anything, it is the proposition that this Court will not examine the minutiae of utility ratemaking decisions in order to determine whether each element of those decisions is constitutional. Rather, the Court said, it will look to the "end result" of those decisions. As stated by the Court:

> Under the statutory standard of "just and reasonable" it is the result reached not the method employed which is controlling. It

> is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end.

320 U.S. at 590.

The Court in Hope thus essentially adopted the view of the concurring opinion of Justice Douglas (the author of the Hope opinion), Justice Black and Justice Murphy in FPC v. Natural Gas Pipeline Co., 315 U.S. 575, 607 (1942), that:

> Irrespective of what the return may be on "fair value," if the rate permits the company to operate successfully and to attract capital all questions as to "just and reasonable" are at an end so far as the investor interest is concerned.

(Emphasis added).

The decision in Hope put an end to an era of federal judicial intervention in ratemaking decisions in which the courts, including the lower court in the Hope case, had ruled that, as a matter

of constitutional right, the "fair value" of the property on which a utility's rates were set had to include some measure of present value or reproduction cost, rather than be based upon the original or historical cost of the property. The thrust of the Hope decision, therefore, was to limit the role of the federal courts in examining the minutiae of regulatory rate decisions and, particularly, to insure that those courts remained out of the business of determining how the value of utility property in rates must be calculated.

That the Hope decision was intended to serve as a basis for judicial restraint in the review of ratemaking decisions and not as a source of newly created constitutional rights for utility investors was made abundantly

clear in a unanimous Supreme Court Opinion issued in 1945, just one year after the Hope case was decided. Market Street Railway Co. v. Railroad Commission, 324 U.S. 548 (1945).

In Market Street Railway, a financially distressed street railway company argued that the rate it had been granted was "confiscatory by the tests of Federal Power Commission v. Hope Natural Gas Co.," because it did not insure the financial integrity of the enterprise. Id. at 566. In the Opinion by Justice Jackson, the Court responded:

> It was noted in the Hope Natural Gas case that regulation does not assure that the regulated business make a profit. 320 U.S. at 603; see Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575, 590. All that was held was that a company could not complain if the return which was allowed made it possible for the company to operate successfully.

Id. (emphasis added).

In Market Street Railway, the Court upheld a six-cent fare, which allowed the company a six percent return on a rate base of $7,950,000. 324 U.S. at 557. This rate base valuation, which was equal to the price at which the company had offered to sell its operating properties to the municipality which it served, was attacked by the utility as confiscatory, id. at 564, but was upheld by this Court even though the book value of the company's property was $41,768,505 and a valuation study of the properties' "historical reproduction cost" indicated a current value of $25,343,543. Id. Indeed, the Company argued that the valuation of its property

> did not consider reproduction cost, historical cost, prudent investment, or capitalization bases, on any of which under conventional accounting the six-cent fare would produce no return on its property and would force a substantial operating deficit upon the Company.

Id. at 553-54 (emphasis added). As noted above, the Court rejected the Company's contention that the rate order was "confiscatory" under the Hope case. Rather, Justice Jackson wrote in the Court's unanimous opinion that:

> Without analyzing rate cases in detail, it may be safely generalized that the due process clause never has been held by this Court to require a commission to fix rates on the present reproduction value of something no one would presently want to reproduce, or on the historic valuation of a property whose history and current financial statements showed the value no longer to exist, or on an investment after it has vanished, even if once prudently made, or to maintain the credit of a concern whose securities already are impaired. The due process clause has been applied to prevent governmental destruction of existing economic values. It has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces.

Id. at 567 (emphasis added).

The above analysis is particularly relevant here. The potential value of

the utilities' investment in the plants at issue "vanished" when those plants were cancelled by the utilities as a result of economic forces.* Even if that investment was prudently made, the Court held in Market Street Railway, the Constitution does not mandate that the value of the investment be restored at the expense of ratepayers.

Nor is this position altered by this Court's subsequent opinion in the Permian Basin Area Rate Cases, 390 U.S. 747 (1968). There, after acknowledging the investor interests identified in Hope, the Court noted that, while these criteria "remain pertinent," they "scarcely exhaust the relevant

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* The reasons for the utilities' decision to cancel these units are discussed at page 4 of the Appellants' Jurisdictional Statement. These factors included a sharp decline in expected growth of electricity demand and the accident at Three Mile Island.

considerations." Id. at 791. The Permian Basin decision also reiterated the rulings of the Court in FPC v. Natural Gas Pipeline Co., 315 U.S. 575 (1942), that the "just and reasonable" standard of the Natural Gas Act "coincides" with the applicable constitutional standards, and that "any rate selected from the broad zone of reasonableness permitted by the Act cannot properly be attacked as confiscatory." 390 U.S. at 770.

In the present appeal, the Companies have not alleged -- nor could they allege with any degree of veracity -- that the disallowance of their claims for cancelled plant costs would turn the overall substantial rate increases granted in these cases from a constitutional to an unconstitutional "end result". It would be an exceedingly

small "zone of reasonableness" if this Court were to hold, as a matter of constitutional law, that the $105,850,000 annual rate increase granted by the Commission in the Duquesne rate case would be transformed into an unconstitutional taking if that increase were reduced to $102.4 million as a result of the disallowance of the Company's abandoned plant claim. Similarly, Penn Power cannot reasonably allege that the difference between the $15,364,000 rate increase it received and the $14.4 million increase it would have received if its abandoned plant claim had been denied renders the end result unconstitutional.

In their arguments to this Court, the Companies are claiming that their investors have a constitutionally protected interest in the recovery of this particular investment. Yet, this

is the very antithesis of the type of argument which a utility must make in order to make even a colorable constitutional claim under the Hope case. As stated by the Court: "If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end." Hope, 320 U.S. at 602 (emphasis added).

The Hope case does not mandate, nor does it outlaw, any particular rate-making methodology or any particular treatment of any specific investment. The investor interests described in Hope clearly pertain to the overall level of rates, not to the investment in any particular asset. Even if Hope were interpreted to support a constitutionally protected investor interest in an overall rate level that permits a financially viable utility, this

interest simply has not been brought into issue by the relatively minor rate adjustments that may result from the Pennsylvania Supreme Court decision in this case.

For this reason, the Appellants' reliance on the decision of the D.C. Circuit Court of Appeals in Jersey Central Power & Light Co. v. FERC, 810 F.2d 1168 (D.C. Cir. 1987) (en banc) is also misplaced. In that case, the utility appealed FERC's summary rejection of its request for a hearing on whether its claim for a partial return on abandoned power plant costs (or, alternatively, for a higher return on its other assets) was appropriate under the Hope end result test. FERC denied the company a hearing, even though the Company alleged that it was in significant financial distress and that the rate increase requested was

"the minimum necessary to restore the financial integrity of the Company." 810 F.2d at 1178. Writing for the majority of a sharply divided court, Judge Bork stated that Jersey Central was entitled to a hearing on its claims. Judge Bork carefully limited the scope of the Court's holding, however, as follows:

> Under Hope, as we have stated repeatedly, the only circumstances under which there is a possibility of a taking of investors' property by virtue of rate regulation is when a utility is in the sort of financial difficulty described in Justice Douglas' opinion. If a utility is in that state, the Commission must inquire whether a reasonable return -- on investment, not on facilities -- has been afforded to investors, taking into account whether any higher return would amount to exploitation of consumers. Under those circumstances, it may be permissible or even proper to grant the utility a greater return on its prudent investments than it otherwise would have received. But absent the sort of deep financial hardship described in Hope, there is no taking, and hence no obligation to compensate, just because a prudent investment has failed and produced no return.

Id. at 1181 n.3 (emphasis added).

While the OCA has argued -- and the Pennsylvania Supreme Court has held, see Pennsylvania Electric, supra -- that the used and useful principle may be applied even where the application of that principle results in financial distress to the utility, the point here is that the Jersey Central decision is not even relevant to the facts of this case.

In the rate case here on appeal, Duquesne Light Company was authorized to earn a 16.14 percent common equity return and 11.64 percent overall return on a rate base of nearly $1.8 billion. (App. 19c, 93c). The total allowed annual revenues to the Company resulting from the $105,850,000 rate increase was more than $800 million. (App. 126c). Clearly, the $3.5 million annual

amortization for cancelled plant costs which would be disallowed under the Pennsylvania Supreme Court's Order would have a relatively minor effect on the "end result" of the Commission's Order.

Similarly, in its rate case, Penn Power was authorized to charge a 15.72 percent return on common equity and a 12.02 percent overall return on a rate base of approximately $400 million. (App. 5e, 48e). The Company's $15,364,000 rate increase in this case brought its total annual revenues to $184,186,000. (App. 3e, 4e). Penn Power's annual amortization claim for the cancelled plants at issue here amounted to $956,967.

While the present case presented an important issue of state public utility law and public policy, and the OCA does not contend that the amounts involved are de minimis, the OCA submits that

this issue and this case come nowhere close to raising the "taking" issue addressed by the majority opinion in Jersey Central, supra.

Even if there could be a case in which the denial of recovery of cancelled plant costs raises a taking issue under the Hope end result test, this case certainly isn't it.*

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* Appellants' reliance on confiscation cases from outside the ratemaking context is also misplaced. Jurisdictional Statement at 23-24 and notes 24, 25. Thus, for example, while the case of Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419 (1982) did involve only a small area of physical intrusion, the Court made it clear in that case that, where government action involves the "permanent physical occupation of property", a taking will be found "without regard to whether the action achieves an important public benefit or has only minimal economic impact on the owner." 458 U.S. at 434-35. Moreover, the Court in Loretto reiterated the statement in Andrus v. Allard, 444 U.S. 51, 66 (1979), that

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footnote continued

C. The Appellants' View Of The Role Of State Legislatures In The Ratemaking Process Is Not Supported By Hope. Moreover, The Appellants' Attacks On The Pennsylvania Legislative Process In This Case Are Unwarranted And Do Not Constitute Grounds For Reversal By This Court.

The Appellants' challenge to the Pennsylvania Supreme Court decision extends to all the ratemaking provisions of the Pennsylvania Public Utility Code. See Jurisdictional Statement at 11, note 9; Appellants' Appendix L. The constitutional deficiency of these

continuation of footnote

"loss of future profits -- unaccompanied by any physical property restriction -- provides a slender reed upon which to rest a takings claim." 458 U.S. at 434, note 10. In the present case, the sole impact of the disallowance ordered by the Pennsylvania Supreme Court is to reduce by a slight margin the Appellants' overall profit levels. The Appellants were not prohibited from constructing the plants by the PUC or any governmental authority, nor was there a physical intrusion of any kind.

provisions, according to the Company, is that they purportedly "prohibit any consideration of selected constitutionally pertinent facts in fixing utility rates." Jurisdictional Statement at 17 (emphasis in the original). Thus, any ratemaking statutes which contain per se rules -- such as the exclusion of costs of non-used and useful investments -- must be unconstitutional in Appellants' view, because such rules preclude the "balancing" of investor and ratepayers interests mandated in Hope.

The OCA submits that Appellants' view of the legislative and ratemaking process stands the Hope decision on its head. As demonstrated in the previous section of this Argument, under Hope, it is the "total effect of the rate order" which is relevant to any constitutionally protected investor interests. 320

U.S. at 590. While each component of a Commission decision must be consistent with state law and supported by substantial evidence, see, e.g., Pennsylvania Power & Light Co. v. Pennsylvania Public Utility Commission, 101 Pa. Commw. 370, 373-74, 516 A.2d 426, 429 (1986), this Court made it clear in Hope that a rate determination cannot be deemed deficient on federal constitutional grounds unless the overall end result is so low as to be confiscatory. As long as the end result is not constitutionally deficient, the Court said in Hope, "[t]he fact that the method employed to reach that result may contain infirmities is not then important." 320 U.S. at 602.

Under the Appellants' apparent view of public utility regulation, the ratemaking chapters of the public

utility codes of each of the 50 states would only be allowed to consist of one sentence: "Rates must be just and reasonable." Indeed, since the just and reasonable standard has been held to "coincide" with the standards of constitutional review, a simple reference to the Fifth and Fourteenth Amendments to the Constitution would suffice, and the need for any public utility code would be eliminated. The OCA submits that such a position is absurd on its face and, in any case, is not constitutionally required.

The Pennsylvania General Assembly has, in fact, established in Section 1301 of the Public Utility Code, 66 Pa. Cons. Stat. §1301, that all rates charged by Pennsylvania utilities must be "just and reasonable." Like many state legislatures, however, the Pennsylvania legislature has not chosen

to issue a one-sentence long Public Utility Code. Rather, the General Assembly has gone on to provide specific substantive and procedural directions to the Public Utility Commission which must be followed by the Commission in setting just and reasonable rates. These provisions do not repeal the overriding statutory and constitutional requirement that overall rate levels must be just and reasonable. Rather, they provide specific instructions on how certain sub-issues must be addressed in making that ultimate determination. While the legislature theoretically could have granted its ratemaking agency absolutely unbridled discretion in setting rates under the just and reasonable standard, it has chosen not to do so. There is certainly nothing constitutionally defective about this choice,

particularly since the Pennsylvania Public Utility Code retains the just and reasonable standard as its overriding rate requirement.

In arguing that absolute discretion for commissions is constitutionally required, the Appellants clearly misperceive the relative standing of the state legislatures and the state public utility commissions in the ratemaking process.

Public utility commissions are nothing more than administrative arms of the state legislatures which create them. As stated by the Pennsylvania Supreme Court in the present case:

> It is clear, beyond any need for citation, that the function of ratemaking for public utilities is legislative in nature. The Commission is but an instrumentality of the state legislature for the performance of that function; and the agency has only such powers as are expressly conferred upon it by statute or exist by necessary implication.

532 A.2d at 339. (App. 30a). See also Minnesota Rate Cases, 230 U.S. 352, 433 (1912) ("The rate-making power is a legislative power and necessarily implies a range of legislative discretion. We do not sit as a board of revision to substitute our judgment for that of the legislature, or of the commission lawfully constituted by it, as to matters within the province of either.")

Since the state legislatures could (and formerly did) set the rates of the utilities in their jurisdictions themselves, it is certainly within their powers to provide specific statutory directions to the commissions they have created to carry out those duties. Unless such specific legislative directions necessarily preclude the setting of just and reasonable rates on an

overall basis, they cannot be found, in and of themselves, to be unconstitutional.

In the present case the Appellants add little to their argument by attacking the Pennsylvania General Assembly as "incoherent" and "manipulative" in their "tinkering" with the Public Utility Code. Jurisdictional Statement at 17, 20. No doubt, utilities would prefer to set their own rates, but because of their natural monopoly status, such legislative "tinkering" has been deemed to be an economic necessity in this country for at least the last 100 years. See, e.g., Munn v. Illinois, 94 U.S. 113 (1876); FPC v. Hope Natural Gas Co., 320 U.S. 591, 610 (1944) ("The primary aim of this legislation [the Natural Gas Act] was to protect consumers against

exploitation at the hands of natural gas companies.")

As evidence of the "lack of coherence" in the Pennsylvania ratemaking process, the Appellants cite the fact that the Pennsylvania General Assembly has now amended the Public Utility Code to permit the recovery of cancelled plant costs. Section 520 of the Public Utility Code, 66 Pa. Cons. Stat. §520. Jurisdictional Statement at 20. The Appellants note that this amendment was applied only prospectively, that is, to plants cancelled after the enactment of the statute on October 10, 1985. Appellants note somewhat cryptically that this date was "conveniently subsequent to the well-known January 22, 1980 cancellation date of the four CAPCO units." Id.

What Appellants fail to point out to this Court is that the primary -- and

indeed, to date, the sole -- beneficiary of this legislative "manipulation" has been Duquesne Light Company. Just prior to its 1986 rate case before the PUC, Duquesne announced the abandonment of its interest in the completion of the partially constructed Perry 2 nuclear power plant. At the time, the Company had invested $154.1 million in Perry 2. In its rate order in Pennsylvania Public Utility Commission v. Duquesne Light Co., No. R-860378 (Pa. PUC, March 10, 1987), the Commission approved the Company's request to charge that entire amount to ratepayers over a ten-year period at a rate of $15.4 million per year. Slip. Op. at 86-91 (Available on Lexis, Pa. Library, PA PUC File). The Commission stated that it was approving the amortization "in accordance with Section 520 of the Public Utility

Code". Id. at 91. No appeal on this issue was taken by any party.

The OCA submits that this statutory change was not the result of either manipulation or incoherence, but rather illustrates the proper exercise of public policy determinations by a state legislature. In balancing the interests of ratepayers and investors, the General Assembly determined that it was appropriate to create a specific exception in Section 520 to the general rule of Section 1315 against the inclusion in rates of the costs of non-used and useful property. Like many legislative enactments, this law was put into effect prospectively only, and thus applied to Duquesne's substantial investment in Perry 2, but not to its much lesser claim for the costs of the plants involved in this case. If anything, the

fact that the law in Pennsylvania has now been amended to permit the very result requested by the Appellants in this case makes the present appeal even less of an appropriate candidate for plenary consideration by this Court, and makes the Appellants' attack on the Pennsylvania General Assembly's actions all the more inexplicable.

More importantly, however, regardless of one's views of the legislative process in this case, it is not the province of this Court to substitute its economic and policy judgments for those of the Pennsylvania General Assembly. As stated by Justice Black in his Opinion for the Court in Ferguson v. Skrupa, 372 U.S. 726, 731-32 (1962):

> We refuse to sit as a "super legislature to weigh the wisdom of legislation," and we emphatically refuse to go back to the time when courts used the Due Process Clause

> "to strike down state laws, regulatory of business and industrial conditions, because they may be unwise, improvident, or out of harmony with a particular school of thought." Nor are we able or willing to draw lines by calling a law "prohibitory" or "regulatory." Whether the legislature takes for its textbook Adam Smith, Herbert Spencer, Lord Keynes, or some other is no concern of ours.

(Footnotes omitted).

Contrary to the Appellants' arguments here, the OCA submits that the Pennsylvania General Assembly has acted properly in setting forth specific directions to the Public Utility Commission in carrying out its duties to set public utility rates which are just and reasonable to both ratepayers and investors. While the Appellants may prefer certain of those directions over others, that is a matter of no constitutional moment and is certainly not a proper grounds for appeal to this Court.

CONCLUSION

Appellants have raised no substantial federal questions which would merit plenary consideration by this Court. The Pennsylvania Office of Consumer Advocate therefore respectfully urges the Court to dismiss this appeal. Alternatively, the Court should affirm the October 15, 1987, Opinion of the Pennsylvania Supreme Court in this matter.

Respectfully submitted,

Irwin A. Popowsky*
Daniel Clearfield
Pamela Bishop Sarvey
Assistant Consumer Advocates

Counsel for Appellee
David M. Barasch
Consumer Advocate

Office of Consumer Advocate
1425 Strawberry Square
Harrisburg, PA 17120
(717) 783-5048

DATED: February 11, 1988

*Counsel of Record

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No. 87-1160

In The Supreme Court of the United States

OCTOBER TERM, 1987

DUQUESNE LIGHT COMPANY
AND
PENNSYLVANIA POWER COMPANY
Appellants,

v.

DAVID M. BARASCH,
CONSUMER ADVOCATE, et al.
Appellees.

On Appeal from the Supreme Court of Pennsylvania

APPELLANTS' BRIEF IN OPPOSITION TO MOTION TO DISMISS OR AFFIRM

ALAN L. REED
WILLIAM E. ZEITER*
JOHN F. STILLMUN, III

MORGAN, LEWIS & BOCKIUS
2000 One Logan Square
Philadelphia, PA 19103
(215) 963-5367

CHRISTINE A. HANSEN
RICHARD S. CHRISTNER
LARRY R. CRAYNE
DUQUESNE LIGHT COMPANY
1 Oxford Centre
301 Grant Street
Pittsburgh, PA 15279

JAMES R. EDGERLY
STEPHEN L. FELD
PENNSYLVANIA POWER COMPANY
1 East Washington Street
New Castle, PA 16103-0891

Attorneys for Duquesne Light Company and Pennsylvania Power Company

February 17, 1988

*Counsel of Record

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The principal arguments advanced by Appellee David M. Barasch ("the Consumer Advocate") in support of his Motion to Dismiss or Affirm serve only to confirm that state-level understanding of this Court's Fifth and Fourteenth Amendment jurisprudence has drifted far wide of the mark during the decades since this Court last gave plenary consideration to a state rate order, and that there is a compelling need for guidance from this Court.

First, the Consumer Advocate accuses Appellants of seeking "to return to an era of judicial review where the minutiae of each rate decision were separately judged for their constitutional validity." (Motion to Dismiss or Affirm, p. 15.) This statement is remarkable in light of the Consumer Advocate's own reliance on the "used and useful" test and an "unbroken series of Supreme

Court decisions" (Motion, pp. 21-22) from the era predating this Court's seminal decision in *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).[1] The "used and

[1]In a futile attempt at presenting three examples of post-*Hope* authority, the Consumer Advocate cites cases that are simply irrelevant to this appeal. *Market Street Railway Co. v. Railroad Commission*, 324 U.S. 548 (1945), for example, is inapposite because it involved a utility that was unable to attract enough customers to permit it to generate revenues sufficient to cover its expenses. As a result, the alleged insufficiency of the rate order resulted from market forces rather than a regulatory decision, and hence was not a taking by a state. In contrast, both Appellants could recover from their customers the amortization at issue in this case if it were allowed to be included in rates. Their inability to recover such expense is thus the result of state action, and not market forces.

Pennsylvania Electric Co. v. Pennsylvania Public Utility Comm'n, 509 Pa. 324, 502 A.2d 130 (1985) *appeal dismissed*, 476 U.S. 1137 (1986), is distinguishable on its facts. Unlike Appellants, the utilities in *Pennsylvania Electric* sought to employ *Hope* as a guarantee of a utility's financial viability. The balance of investor and consumer interest is obviously different where a facility is destroyed as a result of the "most serious [operational failure] in the history of nuclear power generating facilities in the United States," as in *Pennsylvania Electric*, 509 Pa. at 326, 502 A.2d at 131, than it is where, as in this appeal, a plant for which pre-construction expenses were incurred at the instigation of the state regulatory agency and in response to state statutory requirements for service reliability is prudently cancelled in the face of unforeseeable changes in demand for electricity.

Natural Gas Pipeline Co. v. FERC, 765 F.2d 1155 (D.C. Cir. 1985) *cert. denied* 474 U.S. 1056 (1986) applied the used and useful standard as a ratemaking principle, but, unlike the Pennsylvania Supreme Court in this case, also examined the balance between investor and consumer interests. The Court in *Natural Gas* also expressly distinguished the denial of a recovery of investment in unsuccessful experimental gas generation facilities in that case from cases permitting recovery of investment in cancelled electric generating plants. 765 F.2d at 1166-67.

Finally, the Consumer Advocate's quotation of the concurring opinion in a pre-*Hope* case, *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 607 (1942) requires amplification. The quoted sentence as it appears in the Consumer Advocate's Motion (Motion, p. 28) implies that the only constitutionally protected investor interests are those consistent with successful operations and the attraction of sufficient capital. That sentence, however, refers only to commission treatment of capital charges, i.e., a return *on* the shareholder's investment. Earlier on the same page, the concurring justices had stated that "[t]he investor interest is adequately served if the utility is allowed to earn the cost of service," and made clear that the cost of service included expenses. *Id.* Appellants have never sought to capitalize their investment in the four CAPCO units, but instead have sought only a recovery *of* their costs incurred in connection with such units as an amortization expense.

useful" test was at the time of *Hope* only one of several ratemaking principles that were employed as part of the constitutionally mandated "fair value" methodology required by the now-obsolete *Smyth v. Ames*, 169 U.S. 466 (1898) line of cases. The Consumer Advocate, like the Supreme Court of Pennsylvania in its decision below, seeks in this case to elevate the "used and useful" principle to a limitation of constitutional dimension on the recovery of utility investment that overrides the balancing of investor and consumer interests required by *Hope* and *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968).[2]

The Consumer Advocate regards *Hope* as representing merely a doctrine of judicial restraint. In the view of the Consumer Advocate, there can be no cognizable Fifth or Fourteenth Amendment claim unless the impact of a state rate order is to bring the regulated utility to the brink of bankruptcy. The Consumer Advocate cites no reason, for there is none, why in the public utility field—as opposed to any other area of state economic regulation—a litigant should be required to demonstrate virtual economic destruction as a prerequisite to standing

[2]The Consumer Advocate's limitation of his discussion of *Permian*, this Court's most recent Fifth Amendment ratemaking decision, to the quotation of one sentence (Motion, p. 33-34), makes clear that neither the Consumer Advocate nor the Pennsylvania Supreme Court recognize that *Permian* stated a two-part standard: *If* the balancing procedure of *Permian* is followed faithfully by the ratemaking agency, 390 U.S. at 792, *then* "any rate selected from the broad zone of reasonableness" meets Fifth Amendment requirements, 390 U.S. at 770. The essence of this appeal is that the judgment below frustrated the PUC's attempt to adhere to the broadly inclusive *procedural* requirements of *Permian*, 390 U.S. at 792. These procedural requirements were recognized by the *Permian* Court to be essential as a matter of fairness in view of the relatively unstructured nature of the substantive standards of *Hope*.

to advance federal constitutional claims. Certainly *Permian* does not stand for that proposition.

The record in this case establishes an investor expectation for recovery *of* at least some part of the prudent investment undertaken at the instigation of state authorities and in response to statutory requirements for the provision of adequate electric energy supplies. The record also demonstrates the unfairness and irrationality of the effects of Act 335 and other Pennsylvania ratemaking legislation. Yet, in the face of that record, the Consumer Advocate feels free to make the broad assertion that a solvent utility can obtain no relief in this Court from the effects of a state ratemaking statute, no matter how unfair or irrational that statute may be.

As *Permian* makes clear, the "end result" aspect of *Hope* neither eliminates judicial review nor represents a bright-line guarantee of a utility's financial viability. Rather, the "end result" sought to be achieved is a utility rate order that reflects a balancing of investor and consumer interests, regardless of the numerical level of the utility's allowed rate of return. The PUC understood this teaching and struck a balance in this case. In justifying its interpretation of a statute that reduced Appellants' rates below the level of the balance struck by the PUC, the Supreme Court of Pennsylvania did not examine the balance of investor and consumer interests, but instead retrieved a ratemaking methodology from this Court's pre-*Hope* jurisprudence and invested that methodology with a contemporary constitutional dimension. Reversing that anachronistic approach would not set this Court on a course of reviewing the

"minutiae" of every state rate order, but rather would serve to instruct state ratemakers, legislators and courts not to ignore, and instead to be faithful to, the balancing of interests mandated by *Hope* and *Permian*.

The Consumer Advocate also argues (Motion, pp. 42-54) that a state legislature in enacting state ratemaking legislation is entirely unrestrained by this Court's Fifth and Fourteenth Amendment jurisprudence. So long as the Johnson Act, 28 U.S.C. § 1342, is given effect and this Court declines to review state rate orders, that may well be the rule in practice. On principle, however, it is just as impossible to reconcile with the Supremacy Clause a state's interference with a public utility's Fifth Amendment rights as it is to justify any other state attempts to restrict federally-created rights.

Given that many state legislatures seek to have their state ratemaking agency set rates at the lowest level consistent with the Fifth Amendment, there is much to be said for the Consumer Advocate's assertion (attributed to Appellants) that a state could legislate an effective ratemaking rule based on a one sentence "just and reasonable" standard. Pennsylvania, in fact, adhered to such a rule from 1937 until the Arab Oil Embargo. In any other area of Fifth Amendment practice it would be unthinkable for a litigant seriously to advance the proposition that a state legislature may denigrate from the applicable federal constitutional standard, e.g., by mandating a 10% deduction from the value of a Fifth Amendment compensation award to a condemnee for property condemned between January 22, 1980 and October 10, 1985, or by excluding constitutionally required valuation evidence. *See Monongahela*

Navigation Co. v. United States, 148 U.S. 312, 327 (1893).[3] Yet, those examples reflect the operative effect that Act 335 and other Pennsylvania ratemaking legislation, as those statutes have been construed and applied by the Supreme Court of Pennsylvania, would have on Appellants.

Reduced to its essence, the Consumer Advocate's position is one of judicial practicality. In light of the Johnson Act, which burdens this Court with the exclusive task of vindicating the Fifth Amendment rights of public utilities in a federal forum, it is said to be impractical for the federal judicial system to enforce such rights. From that proposition, it is an easy transition to the erroneous conclusion that there are no rights to enforce. With respect, Appellants believe that such a position demeans both this Court's traditional status as the ultimate guardian of federal constitutional rights and this Court's capacity to deploy effectively its limited judicial resources.

[3]In *Monongahela*, this Court held that Congress could not statutorily preclude the courts from considering the value of a company's franchise to collect tolls in determining the amount to be paid as compensation for the government's condemnation of a lock and dam belonging to the company. This Court stated:

> By this legislation congress seems to have assumed the right to determine what shall be the measure of compensation. But this is a judicial, and not a legislative, question. The legislature may determine what private property is needed for public purposes; that is a question of a political and legislative character. But when the taking has been ordered, then the question of compensation is judicial. It does not rest with the public, taking the property, through congress or the legislature, its representative, to say what compensation shall be paid, or even what shall be the rule of compensation. The constitution has declared that just compensation shall be paid, and the ascertainment of that is a judicial inquiry.

148 U.S. at 327. In contrast to the historic cases cited by the Consumer Advocate, *Monongahela*, although nearly a century old, remains a vital part of this Court's current Fifth Amendment jurisprudence. *See e.g. First English Evangelical Lutheran Church of Glendale v. County of Los Angeles*, 107 S.Ct. 2378, 2385 (1987); *Blanchette v. Connecticut General Ins. Corp.*, 419 U.S. 102, 150 n. 39 (1974).

A wide range of feasible actions are available to this Court that would both serve to remind state ratemakers, legislators and courts that utility investors continue to enjoy the protections of the Fifth and Fourteenth Amendments, and avoid re-establishing this Court as a routine participant in state ratemaking decisions. One such action, which would accomplish both objectives, would be a reversal of the judgment below on the ground that Act 335 and related Pennsylvania ratemaking legislation are inconsistent with the requirement of *Permian* that "each of the pertinent factors" be balanced in setting rates.

CONCLUSION

The Court should note probable jurisdiction and reverse the judgment below.

Respectfully submitted,

ALAN L. REED
WILLIAM E. ZEITER*
JOHN F. STILLMUN, III

MORGAN, LEWIS & BOCKIUS
2000 One Logan Square
Philadelphia, PA 19103
(215) 963-5367

CHRISTINE A. HANSEN
RICHARD S. CHRISTNER
LARRY R. CRAYNE
DUQUESNE LIGHT COMPANY
1 Oxford Centre
301 Grant Street
Pittsburgh, PA 15279

JAMES R. EDGERLY
STEPHEN L. FELD
PENNSYLVANIA POWER COMPANY
1 East Washington Street
New Castle, PA 16103-0891

Attorneys for Duquesne Light Company and Pennsylvania Power Company

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*Counsel of Record

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No. 87-1160

In The Supreme Court of the United States

OCTOBER TERM, 1987

DUQUESNE LIGHT COMPANY
AND
PENNSYLVANIA POWER COMPANY
Appellants,

v.

DAVID M. BARASCH,
CONSUMER ADVOCATE, et al.
Appellees.

On Appeal from the Supreme Court of Pennsylvania

BRIEF FOR APPELLANTS

ALAN L. REED
WILLIAM E. ZEITER*
JOHN F. STILLMUN, III

MORGAN, LEWIS & BOCKIUS
2000 One Logan Square
Philadelphia, PA 19103
(215) 963-5367

CHRISTINE A. HANSEN
RICHARD S. CHRISTNER
LARRY R. CRAYNE
DUQUESNE LIGHT COMPANY
1 Oxford Centre
301 Grant Street
Pittsburgh, PA 15279

JAMES R. EDGERLY
STEPHEN L. FELD
PENNSYLVANIA POWER COMPANY
1 East Washington Street
New Castle, PA 16103-0891

Attorneys for Duquesne Light Company and Pennsylvania Power Company

May 5, 1988

*Counsel of Record

QUESTIONS PRESENTED

1. Does the Pennsylvania Supreme Court's interpretation of Act 335 and other unspecified Pennsylvania ratemaking legislation effect a taking of property in violation of the Fifth and Fourteenth Amendments by precluding the state ratemaking agency from considering constitutionally pertinent factors in determining whether to permit recovery of prudently incurred investment in cancelled electric generating units?

2. Does the Pennsylvania Supreme Court's interpretation of Act 335 and other unspecified Pennsylvania ratemaking legislation to deny utility investors any recovery of or on prudently incurred investment in cancelled electric generating units effect a taking of property in violation of the Fifth and Fourteenth Amendments where the state ratemaking agency has concluded that the appropriate balance between investor and consumer interests requires the recovery of such investment?

PARTIES BELOW

In addition to David M. Barasch, Consumer Advocate, the appellants below were Equitable Life Assurance Society, Joseph Horne Company, Kaufman's and Gimbels. The Pennsylvania Public Utility Commission was the appellee below. Appellants Duquesne Light Company and Pennsylvania Power Company were intervenors below.

STATEMENT OF CORPORATE RELATIONSHIPS

Appellant Pennsylvania Power Company is a wholly owned subsidiary of Ohio Edison Company.

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In The Supreme Court of the United States

OCTOBER TERM, 1987

No. 87-1160

DUQUESNE LIGHT COMPANY
AND
PENNSYLVANIA POWER COMPANY
Appellants,

v.

DAVID M. BARASCH,
CONSUMER ADVOCATE, ET AL.
Appellees.

On Appeal from the Supreme Court of Pennsylvania

BRIEF FOR APPELLANTS

Duquesne Light Company ("Duquesne") and Pennsylvania Power Company ("Penn Power") appeal from the final judgment of the Supreme Court of Pennsylvania, dated October 15, 1987, holding that Act 335, as incorporated in 66 Pa.C.S. § 1315, is not unconstitutional as being violative of the Fifth and Fourteenth Amendments to the Constitution of the United States.

OPINIONS BELOW

The opinion of the Supreme Court of Pennsylvania (App. A)[1] is reported at 516 Pa. 142, 532 A.2d 325 (1987). The opinion of the Commonwealth Court of Pennsylvania (App. B) is reported at 90 Pa. Cmwlth. 98, 494 A.2d 58 (1985). The Opinion and Order of the

[1]By Order dated April 18, 1988, this Court granted Appellants' Motion to Dispense with Printing of the Joint Appendix. All references to "App." are to Appellants' Appendix to Jurisdictional Statement.

Pennsylvania Public Utility Commission ("PUC") in Duquesne's case (App. C) is reported at 51 P.U.R.4th 198 (1983). The PUC's Opinion and Order Upon Reconsideration in Duquesne's case (App. D) is reported at 52 P.U.R.4th 644 (1983). The PUC's Opinion and Order in Penn Power's case (App. E) is reported at 60 P.U.R.4th 593 (1984).

JURISDICTION

The Supreme Court of Pennsylvania entered judgment on October 15, 1987. Duquesne and Penn Power filed a timely notice of appeal in the Supreme Court of Pennsylvania on January 7, 1988, and filed a Jurisdictional Statement on January 12, 1988. This Court noted probable jurisdiction by order dated March 7, 1988. This Court has appellate jurisdiction under 28 U.S.C. § 1257(2).

CONSTITUTIONAL AND STATUTORY PROVISIONS

United States Constitution, Amendment V, clause 4:

> [N]or shall private property be taken for public use, without just compensation.

United States Constitution, Amendment XIV, clause 3:

> [N]or shall any State deprive any person of ... property, without due process of law....

Act 335, as incorporated into § 1315 of the Pennsylvania Public Utility Code, 66 Pa.C.S. § 1315, and Chapter 13 of the Pennsylvania Public Utility Code, 66 Pa.C.S. §§ 1301-1325, are reprinted in Appendix L.[2]

[2]The Pennsylvania Supreme Court's wholly unnecessary reinterpretation of unspecified portions of the ratemaking provisions of the Pennsylvania Public Utility Code, so as to render Act 335 consistent with a general prin-

(footnote continued on next page)

STATEMENT OF THE CASE

During the late 1960s, substantial annual increases in the demand for electric power, and the massive New York City and Northeast blackouts, prompted nationwide concern that electric utilities soon would be faced with insufficient generating capacity. In Pennsylvania, the PUC opened an investigation of a perceived failure on the part of Pennsylvania's jurisdictional electric utilities to begin construction of needed plant additions. *See Investigation of the Need for Additional Electric Generating and Transmission Facilities*, 46 Pa. P.U.C. 23 (1972).

This investigation led the PUC to conclude that "a desperate situation was developing" which could "within the near future . . . result in possible blackouts and customer load curtailments." *Id.* at 24. In light of this conclusion, the PUC instructed Pennsylvania's electric utilities "that immediate preparations should be made to increase installed capacity until a reliable reserve of 20% above forecasted loads was reached." *Id. See* App. 16h–17h. *See also, Pennsylvania Public Utility Comm'n v. Metropolitan Edison Co.*, 47 Pa. P.U.C. 56 (1973).[3]

ciple that no utility may *ever* recover its investment in cancelled facilities (App. 25a, 28a–29a) (thereby avoiding Appellants' equal protection arguments advanced below), renders the entire ratemaking chapter of the Code at issue in this case. Consequently, Appellants have printed all of Chapter 13 of the Code (relating to rates and ratemaking) in Appendix L. Throughout this Brief, Appellants refer to the statutes at issue as "Act 335 and other unspecified Pennsylvania ratemaking legislation."

[3]The following passage from the PUC's Opinion in the *Metropolitan Edison* case illustrates the pressures placed on the electric industry in the late 1960s and early 1970s to expand their generating facilities:

> This Commission, and other regulatory bodies consider essential the continuing construction of electric generating capacity to meet the energy needs of the public. Respondent and other electric companies

(footnote continued on next page)

In 1967, Duquesne and Penn Power, along with Ohio Edison Company, The Cleveland Electric Illuminating Company and The Toledo Edison Company, had formed the Central Area Power Coordination Group ("CAPCO"). One of CAPCO's principal objectives was to take advantage of the economies of scale through the joint construction and financing of electric generating facilities. In accordance with this objective, the CAPCO companies, in the early 1970's, authorized the construction of seven large nuclear generating units,[4] including Davis-Besse Unit Nos. 2 and 3 and Erie Unit Nos. 1 and 2, which are the four units at issue in this case (the "four CAPCO units"). Thereafter, each of the member CAPCO companies incurred substantial pre-construction expenses relating to the four CAPCO units.

In January of 1980, prior to the issuance by the Nuclear Regulatory Commission of construction permits for the four CAPCO units, CAPCO announced their cancellation. The intervening events which led to this decision are documented at length in Administrative Law Judge Joseph P. Matuschak's Report of Investigation at Dockets I-79070315 and I-79070317 (Pa. P.U.C.

(Footnote continued from previous page)

> in Pennsylvania are continuing heavy expenditures to add additional generating facilities as rapidly as possible to meet adequately the public demand for service. *To protect the public interest*, this Commission has insisted that construction be accelerated and all feasible methods adopted to meet the present emergency.

47 Pa. P.U.C. at 59. (Emphasis added).

[4]The decision to build nuclear plants was based on a 1973 study that projected 20% lower costs to CAPCO customers for a nuclear plant than for a coal plant of comparable size over the period 1981–2005. (App. 16h–17h) ("The preference of nuclear over coal in this study was on the basis of the lowest cost to the customer.")

October 15, 1982) (App. H) (the "*CAPCO Investigation*").[5] In summary, Judge Matuschak found that the 1974 recession, the mild summers and winters of 1974 and 1975, and, most importantly, the Arab oil embargo had caused wholly unexpected and unforeseeable changes in the previously consistent pattern of annual growth in electric demand confronting Duquesne and Penn Power. When combined with the accident at Three Mile Island in 1979, these circumstances demanded a re-evaluation of CAPCO's construction program. Because these extraordinary events could not have been predicted, and indeed were directly contrary to the consensus demand for expansion of generating capacity that prevailed in the late 1960s and early 1970s, Judge Matuschak concluded that CAPCO, and specifically Duquesne and Penn Power, could not be faulted for having embarked on the construction of the four CAPCO units, nor for their decision to cancel those units in 1980. To the contrary, he found that "the CAPCO decisions in regard to the Davis-Besse 2 and 3 and Erie 1 and 2 nuclear units, at every stage to their cancellation, were reasonable and prudent." (App. 19h)[6]

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[5]The *CAPCO Investigation* resulted from the PUC's decision in July of 1979 to institute proceedings against Duquesne and Penn Power for the purpose of determining whether recently announced delays in a number of CAPCO sponsored nuclear generating stations, including the four CAPCO units, were justifiable. While that investigation was pending before Judge Matuschak, cancellation of the four CAPCO Units was announced. The *CAPCO Investigation* thereafter focused upon, *inter alia*, both the prudence of CAPCO's decision to begin construction of these units and the prudence of CAPCO's later decision to cancel them.

[6]The PUC by Opinion and Order entered January 13, 1983 adopted the Report of Investigation. (App. 1i). This order was never appealed. The PUC later explicated its reasoning in its Opinion and Order Upon Reconsideration in the Duquesne case. (App. 9d). In all proceedings below, the prudent nature of the costs at issue has been undisputed.

Judge Matuschak then recommended that Duquesne and Penn Power be permitted a recovery *of* their investments in the four CAPCO units over a period of ten years but not be allowed to earn any return *on* the amount of their investment remaining to be recovered during the rest of the recovery period, thereby balancing the burden of this loss between the utilities' shareholders and ratepayers.[7] In making this recommendation, Judge Matuschak recognized that "the overwhelming weight of authority" supported the recovery through amortization *of* prudently incurred investment in cancelled electric generating projects. (App. 11h, 19h).[8] The PUC agreed and proceeded to allow Duquesne to begin recovery *of*, but not *on*, its investment in the four CAPCO units by way of a ten-year amortization in its next rate proceeding, which is the rate proceeding at issue in this case. (App. 35c–37c) The

[7]Judge Matuschak's opinion and the papers in this case contain repeated references to a "return *of*" and a "return *on*" electric plant cancellation costs. The difference between these terms is best explained by example. An investor who provides another with funds, e.g., a financial institution which lends funds to a home buyer, expects repayment in two ways. First, the investor desires ultimately to retrieve his or her initial investment, e.g., by periodic amortization or principal payments equalling the amount originally invested. In utility parlance this is referred to as a "return *of*" or "recovery *of*" the investment and usually is accomplished through "amortization" or "depreciation" charges. Second, the investor desires to receive compensation for the use of his or her funds by a periodic payment representing a percentage or other yield on the unrecovered balance of the investment, such as interest payments on a home buyer's loan. In utility parlance the compensation for use of invested funds is referred to as a "return *on*" the investment.

[8]Appellants argue, see note 21 *infra*, that as a matter of law a utility has a *per se* right to a recovery *on* as well as *of* its prudent investment made in fulfillment of its statutory duty to serve. However, in the context of the particular rate proceedings below, Duquesne and Penn Power elected to support Judge Matuschak's resolution of the issue in its entirety, rather than join those attacking his decision. Thus, each utility presented a claim for only a return *of* its investment in the four CAPCO units.

PUC later authorized Penn Power to do the same. (App. 81e–82e).[9]

The PUC's decision in Duquesne's rate case allowing a recovery *of* Duquesne's investment in the four CAPCO units was entered on January 28, 1983. However, after the record had been closed and the issues briefed, but before the PUC's decision in that case, Act No. 1982-335, P.L. 1473 ("Act 335") (App. 6m-7m) was enacted on December 30, 1982, adding Section 1315 to the Pennsylvania Public Utility Code. *See* 66 Pa.C.S. § 1315. Act 335 was adopted in response to public concern that the PUC might depart from its past practice and allow over $500 million of the costs associated with Philadelphia Electric Company's Limerick nuclear generating station then under construction to be included in rate base prior to completion. (App. 6b-7b). Act 335 effectively prohibited the PUC from doing so and, in this respect, served to confirm the PUC's past practice under which such "construction work in progress" costs ("CWIP") were, except in certain circumstances not relevant here, not permitted to be included in rate base until the underlying project or facility had been placed in service (App. 6b-7b; 10b; 12d-14d).[10]

[9]As reflected in the record, Duquesne's claim for such expenses amounted to $34,697,389, before taxes. Penn Power's claim totalled $15,609,628, before taxes. An itemization of total CAPCO expenditures on the four CAPCO units, as submitted by Penn Power to the Federal Energy Regulatory Commission ("FERC") is contained in Appendix J (App. 19j–25j).

[10]A public utility can be compensated in either of two ways for the "time value" of its funds invested in major construction projects with respect to the period between expenditure and completion of the project.

First, the carrying charges on the construction costs may be capitalized as part of the project's historical cost through an "allowance for funds used during construction," (usually abbreviated either AFUDC or AFDC) equal to "the net cost for the period of construction of borrowed

(Footnote continued on following page)

On February 14, 1983, the Pennsylvania Office of Consumer Advocate ("Consumer Advocate") petitioned for reconsideration of the PUC's decision in Duquesne's rate case to allow recovery *of* Duquesne's investment in the four CAPCO units. The Consumer Advocate argued that Act 335 not only prohibited the inclusion of CWIP in rate base, but also prohibited any recovery *of* or *on* investment in cancelled generating units. On April 18, 1983, the PUC issued its Opinion and Order Upon Reconsideration, rejecting the Consumer Advocate's interpretation of Act 335 and affirming its prior ruling. (App. 10d-14d).

In Penn Power's case, the PUC adhered to its decision in Duquesne's case and, by Opinion and Order of April 11, 1984 (App. E), approved rate levels that included Penn Power's expense claim for a recovery, over a ten-year amortization period, *of* (but not a return *on*) its investment in the four CAPCO units.

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funds used for construction purposes and a reasonable rate on" equity used for such purposes. See FERC *Electric Plant Instruction* 3A(17). 18 C.F.R. Part 101 (1987). This approach reduces the rates of ratepayers during the precompletion period, while correspondingly increasing relative rates during the postcompletion period.

Second, the value of the construction investment may, instead, be included in rate base, in the form of CWIP, prior to the completion of construction. Under this approach no AFUDC accrues after the investment is included in rate base. As a result, this approach increases rates during the precompletion period, while correspondingly decreasing relative rates during the postcompletion period. For a further discussion of CWIP and AFUDC, *see generally*, L. SCHWARTZ, J. FLYNN & H. FIRST, FREE ENTERPRISE AND ECONOMIC ORGANIZATION: GOVERNMENT REGULATION 465-492 (6th ed. 1985).

Consequently, an anti-CWIP statute merely *defers* the timing of the receipt by a utility of a return *of* and *on* its construction investment without adversely affecting the economic value of that investment. Because cancelled plants are never completed, application of an anti-CWIP statute to cancellation costs prevents a utility from *ever* receiving a return *of* or *on* its investment in such costs.

In its Opinion and Orders of June 13, 1985, the Commonwealth Court affirmed the PUC's decisions in the Duquesne and Penn Power rate cases, holding that Act 335 was intended only to exclude CWIP from *rate base* and had no applicability to an otherwise proper *expense* reflecting the recovery *of* prudently incurred investment in cancelled electric generating units.[11] (App. 7b-8b).

In a concurring opinion, President Judge Crumlish supplemented the majority's reasoning by observing that the Consumer Advocate's reading of Act 335 would raise "serious constitutional problems" (App. 10b). As had been noted by the Commission below (App. 14d), and as had been argued by Penn Power and Duquesne, such a rule would pose a "real and not fanciful" confiscation issue.

Subsequent to the Commonwealth Court's decision, Act 1985-62, adding § 520 to the Pennsylvania Public Utility Code, 66 Pa.C.S. § 520 was signed into law on

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[11] A utility's *rate base* is that portion of a utility's investment *on* which it is entitled to receive a return. *See Louisiana Public Service Comm'n. v. FCC*, 476 U.S. 355, 365 (1986). As a utility receives a recovery *of* its investment through depreciation charges, the rate base is reduced by the amount of such charges, which are recovered over the life of a plant as operating expenses. This Court has explained:

> The total amount that a [utility] is entitled to charge for services, its "revenue requirement," is the sum of its current operating expenses, including taxes and depreciation expenses, and a return on its investment "rate base." The original cost of a given item of equipment enters the rate base when that item enters service. As it depreciates over time—as a function of wear and tear or technological obsolescence—the rate base is reduced according to a depreciation schedule that is based on an estimate of the item's expected useful life. Each year the amount that is removed from the rate base is included as an operating expenses.

Id. A statute that is intended to exclude an investment from rate base bars only a return *on* such investment, not the recovery *of* such investment.

October 10, 1985. (App. 19m-20m). The Pennsylvania legislature enacted § 520 in response to public pressure to define the PUC's authority to order the cancellation of electrical generating facilities under construction. In combination with the authority to cancel plants under construction, § 520 authorized the PUC to permit recovery *of* prudently-incurred investment in cancelled generating units by way of amortization without a return *on* the unamortized balance, precisely the result endorsed by the PUC and Commonwealth Court in this case. By its terms, however, § 520 applied only to cancellations effected after October 10, 1985.

The Pennsylvania Supreme Court reversed the Commonwealth Court in an opinion dated October 15, 1987. In that opinion, the Court recognized that the PUC had viewed "its decision to permit recovery through amortization" as

> a discharge of its duty to balance the interests of consumers and utility investors when determining what are "just and reasonable" rates.

532 A.2d at 331 (App. 11a). Nevertheless, the Court rejected the statutory construction analysis of the PUC and the Commonwealth Court, finding that the language of Act 335 was unambiguous on its face and applies to bar amortization or, for that matter, any recovery of utility cancellation costs.[12] The court then

[12]To reach this contrived result, the Pennsylvania Supreme Court disregarded the ambiguity in the language of Act 335, ignored the title and preamble to the statute, and refused to acknowledge the statute's legislative history and purpose. As the PUC and the Commonwealth Court recognized, the title and preamble to Act 335, which Pennsylvania permits to be considered in the construction of the statute, *see* 1 Pa.C.S. § 1924, makes it clear that the statute was intended only to limit consideration in *rate base* of the costs specified in the statute. (App. 5b). Moreover, the legis-

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went on to discuss the various constitutional challenges raised by Duquesne and Penn Power.

In addressing the confiscation issue under the Fifth and Fourteenth Amendments to the United States Constitution, the Court cited a multitude of this Court's decisions predating *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), but mentioned neither *Hope* nor this Court's more recent elaboration in *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), nor recognized any obligation to balance investor and consumer interests in evaluating the end result of a utility rate order. 532 A.2d at 335-37 (App. 21a-26a). Instead, the Court merely held that the federal constitution's protection extends only to utility property that is "used and useful" and to operating expenses that represent "a cost of providing *present* utility service." 532 A.2d at 336 (App. 25a) (Emphasis in original).[13]

(Footnote continued from previous page)

lative history of Act 335 makes it clear that the statute was intended solely to address the issue of CWIP, and was enacted specifically to countermand the PUC's assertion in a Philadelphia Electric Company rate order that it possessed the authority to include CWIP in rate base under appropriate circumstances. (App. 7b). Although it referred to several cases in other jurisdictions that ostensibly supported its interpretation of Act 335, the Pennsylvania Court also refused even to acknowledge the decision of the Missouri Supreme Court in *State ex rel. Union Elec. Co. v. Public Service Comm'n*, 687 S.W.2d 167 (Mo. 1985). When presented with essentially the same law and facts as involved in this case, the Missouri Supreme Court in *Union Electric* recognized the serious constitutional infirmities in extending an anti-CWIP statute to cancellation costs, and, unlike the Pennsylvania Supreme Court in this case, avoided reaching the confiscation issue by adopting a limited statutory construction similar to that of the PUC and Commonwealth Court below.

[13]The Pennsylvania Supreme Court also rejected Appellants' equal protection arguments presented below, as well as Appellant Penn Power's constitutional challenge to the Court's interpretation of Act 335 to deny recovery for land held for future use. Appellants have acquiesced in these holdings for the purpose of this case and accordingly the questions presented do not encompass these issues.

SUMMARY OF ARGUMENT

1. The decision below ignored applicable constitutional standards. Under this Court's present jurisprudence, a public utility rate order is not confiscatory in the constitutional sense as long as it comports with the requirements of *Hope* and *Permian*. According to *Hope*, the "end result" of the rate order must reflect a balancing of investor and consumer interests. This Court recognized in *Permian* that the conclusory nature of the *Hope* substantive test demands that special attention be given to the procedures to be followed in assessing the balance between investor and consumer interests. Under the *Permian* procedures the ratemaking tribunal must: (1) consider all constitutionally pertinent factors and (2) articulate the reasons for the balance it strikes. The Pennsylvania Supreme Court ignored *Hope* and *Permian* and sought to invest the "used and useful" test with a contemporary constitutional dimension. The "used and useful" test, however, is a one-dimensional and result-oriented ratemaking device that cannot override the balancing of interests required by *Hope* and *Permian*.

2. The PUC's rate orders below satisfied the *Hope* and *Permian* requirements. The constitutionally pertinent factors that must be considered under *Permian* are those that inform the fairness judgment that is implicit in the concept of "just" compensation. Judge Matuschak's decision, which carefully balanced investor and consumer interests and which properly considered such factors as the fact that the investment at issue had been encouraged or required by state law, the fact that the investment at issue was undertaken to satisfy the consumer interest in uninterrupted electric service, and the fact that the investment at issue had been prudently

incurred, was incorporated by the PUC into the rate orders at issue in this case.

3. The challenged legislation is invalid, both facially and as applied, because it vests the PUC with the function of developing the constitutionally pertinent facts while simultaneously depriving the PUC of the capacity to consider all such facts. A state is essentially free to structure its ratemaking apparatus as it chooses, but the resulting process must at the very minimum permit compliance with the *Hope* and *Permian* standards. The balance between investor and consumer interests depends upon the facts of each case. The fact that an investment has been encouraged or required by state law, the fact that an investment has been undertaken to satisfy the consumer interest in uninterrupted electric service, and the fact that an investment has been incurred prudently are all pertinent to the balancing contemplated by *Hope* and *Permian*. Pennsylvania law, as construed and applied below, prohibits any consideration of these facts. The challenged legislation should be invalidated, thereby reinstating the decisions of the PUC which conformed to applicable constitutional standards.

4. Separate and apart from the PUC's rate orders having satisfied the *Hope* and *Permian* requirements, return *of* the investment in the four CAPCO units is required as a matter of law. A system of regulation (such as Pennsylvania's) that prohibits investor returns in excess of a "reasonable" return creates certain investor expectations. These have included a general expectation that at least some of the risks of loss are shared with the consumer, and a specific expectation that the investor would at least be permitted to obtain the return *of* his or her prudent investment. A rate order that

frustrates reasonable investor expectations is confiscatory. Moreover, recovery *of* their prudent investment is necessary *per se* to ensure that utility investors are "made whole." *Hope*, 320 U.S. at 606, on their investment dedicated to public use.

ARGUMENT

I. The Pennsylvania Supreme Court Ignored The Constitutional Requirement That Public Utility Rate Orders Must Reflect A Balancing Of Investor And Consumer Interests

This Court for many years has equated the "just and reasonable" standard found in most federal and state ratemaking statutes[14] with the minimum constitutional requirement for the protection of utility investors. *See FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942). A rate that falls below the "just and reasonable" standard is "confiscatory in the constitutional sense." *Id.* at 585. In *Hope*, this Court established a balancing test for determining whether rates are "just and reasonable," explaining that the "fixing of 'just and reasonable' rates involves a balancing of the investor and the consumer interests." *Hope*, 320 U.S. at 603.

Hope's balancing test was a major turning point in this Court's takings jurisprudence. Prior to *Hope*, the rule of *Smyth v. Ames*, 169 U.S. 446 (1898) required courts to analyze the "fair value" of each item of utility property. By re-focusing the inquiry from the "fair value" of particular assets to a return *of* and *on* the shareholders' investment, *Hope* freed reviewing courts of the burden of having to scrutinize rate orders in

[14] *See, e.g.*, Federal Power Act, 16 U.S.C. § 824d(a), and the Natural Gas Act, 15 U.S.C. §§ 717c(a), 717d(a).

meticulous detail. The new approach established in *Hope* did not eliminate constitutional review of rate orders, but merely modified the reviewing court's role from analyzing the fair value of utility property to determining whether the "end result" of the rate order represented a balance between investor and consumer interests.[15]

In its broadest sense, the language of *Hope* may seem to suggest that ratemakers are entitled to select even arbitrary methods, as long as an appropriate end result

[15] *Hope* culminated decades of debate concerning the appropriate method by which to protect investors against confiscatory rate orders. Under *Smyth*, the "fair value" placed on the rate base had been tied to current economic conditions and price levels, rather than the original cost of the utility's investment. Beginning with Justice Brandeis' concurring opinion, joined by Justice Holmes, in *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Comm'n*, 262 U.S. 276, 289-312 (1923) (Brandeis and Holmes, JJ. concurring), courts and commentators began questioning the wisdom of the "fair value" method. From a legal standpoint, the task of determining the current "fair value" of utility assets proved "laborious and baffling." *Id.* at 292. As a result, ratemakers were able to articulate a rationale to justify almost any result selected, thus effectively thwarting meaningful judicial review. *Id.* at 296-98 & n. 8. From an economic standpoint, use of the fair value method tended to produce low rates in times of deflation, when the cost of reproducing an asset was less than its historic cost, and tended to produce high rates in times of inflation, when the cost of reproducing an asset exceeded its historic cost. *Id.* at 299-304.

Justice Brandeis advocated the adoption of the "prudent investment" method as an alternative to fair value. *Id.* at 289. Under this method, utility shareholders were to be compensated not for the value of specific tangible and intangible property owned by the utility, but rather for the capital they had prudently invested. *Id.* at 290. The shareholders would be entitled to receive "the reasonable cost of conducting the business," including operating expenses and capital charges. *Id.* at 290-291.

Many of the ideas developed by Justice Brandeis in *Southwestern Bell* found their way into the opinions of this Court, in *Natural Gas Pipeline* and in *Hope*, particularly the shift in focus from assets to investment in analyzing the constitutionality of a rate order.

is somehow reached, because "[t]he fact that the method employed to reach that result may contain infirmities is not then important." *Hope*, 320 U.S. at 602. Such a broad reading of *Hope*'s end result test is, however, incompatible with the constitutional requirement for judicial review. Unless the ratemaker acknowledges its duty to balance and articulates the rationale for the balance it has struck, the reviewing court would be left with a nebulous "result" and no meaningful way of evaluating whether that result reflects a balance of investor and consumer interests.

Thus, in *Permian*, this Court recognized that the conclusory nature of the *Hope* end result test requires that the procedures followed in ratemaking cases insure that the statutorily and constitutionally-mandated balancing of all relevant factors has taken place:

> the [reviewing] court must determine whether the [rate] order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable. The court's responsibility is not to supplant the Commission's balance of these interests with one more nearly to its liking, but instead to assure itself that the Commission has given *reasoned consideration to each of the pertinent factors.* Judicial review of the Commission's orders will therefore function accurately and efficaciously *only if the Commission indicates fully and carefully the methods by which, and the purposes for which, it has chosen to act*, as well as its assessment of the consequences of its orders for the character and future development of the industry.

Permian, 390 U.S. at 792 (emphasis added).

Permian, thus, represented an elaboration of the broad "end result" language of *Hope*. Like *Hope*, *Permian*'s standard of review does not mandate that any particular ratemaking method be selected. However, the ratemaker must inform the reviewing court of the method employed, must consider the pertinent factors, and must explain how, in the judgment of the ratemaker, application of its method to the facts of the case produces an end result that balances investor and consumer interests. The *Permian* procedures become the mechanism that permits the constitutionally required judicial review of *Hope*'s "end result."

In recent years, states have increasingly strayed from the teachings of *Hope* and *Permian*. Since the time of the Arab oil embargo, energy price inflation has produced a substantial decline in the rate of growth of consumer demand for electricity. At the same time, the cost of constructing the many large electric generating facilities, which had been planned during the decades of high growth in electricity demand, have skyrocketed. When faced with requests for rate increases to compensate utility investors for their massive investment in completed plants, and their substantial investment in plants cancelled prudently in face of declining demand, state regulators, state courts and state legislatures have experienced significant public pressure to limit the growth of electric rates.[16] As a result, many such regula-

[16]There are, of course, also important public policy considerations implicated in utility ratemaking, particularly with respect to the relationship between the treatment of the cancellation costs of unneeded plants and the treatment of completed unneeded plants:

> [A] state that prohibits recovery of all investments in canceled plants but permits a rate of return on completed plants that constitute excess capacity creates an incentive to complete a plant whether it is needed

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tors, courts and legislatures have manipulated traditional ratemaking principles in an effort to minimize the resulting rates.

In this case, the Pennsylvania Supreme Court joined the growing number of courts that have completely ignored the constitutional principles of *Hope* and *Permian*.[17] Although it adverted to the PUC's balancing effort below, the Pennsylvania Court, through its interpretation of Act 335 and other unspecified Pennsylvania ratemaking legislation, obliterated the balance struck by the PUC. In doing so, the Court made no effort to determine whether under its construction of the applicable state law "each of the pertinent factors" identified

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or not. A state that disallows investments in excess capacity but permits recovery of investments in canceled plants creates an incentive to cancel a plant if there is any likelihood that its completion will result in excess capacity. A state that precludes recovery of investments in canceled plants and disallows investment in excess capacity creates a third type of incentive: to refrain from constructing a new plant until there is absolute certainty that a new plant is needed.

Pierce, *The Regulatory Treatment of Mistakes in Retrospect: Canceled Plants and Excess Capacity*, 132 U. Pa. L. Rev. 497, 524 (1984) (footnotes omitted). But the fairness considerations implicit in the Takings Clause impose constitutional limits on the ability of states freely to employ these regulatory tools.

[17] *See e.g., Dayton Power & Light Co. v. Public Utilities Comm'n*, 4 Ohio St. 3d. 91, 447 N.E. 2d 733 (1983) ("The federal constitution no longer provides any special protections for utility investors.") The Pennsylvania Consumer Advocate in this case has even argued that *Hope* is merely a doctrine of judicial restraint that eliminates review of state rate orders under the Fifth and Fourteenth Amendments unless the impact of such an order is to bring the regulated utility to the brink of bankruptcy. *See* Motion of Appellee, David M. Barasch, Consumer Advocate, to Dismiss or Affirm, pp. 26-41. There is no reason why in the public utility field—as opposed to any other area of state economic regulation—a litigant should be required to demonstrate virtual economic destruction as a prerequisite to standing to advance federal constitutional claims. Certainly, *Permian* does not stand for that proposition.

in *Permian* could be considered. Instead, the Court leaped backwards over *Hope* and *Permian* to resurrect isolated statements from *Smyth* and its progeny. The Court sought to justify the constitutionality of its statutory interpretation by holding that only "used and useful" property is entitled to constitutional protection.

The "used and useful" test is inconsistent with the balancing of interests required by *Hope* and *Permian*. Like the statutes at issue in this case, the "used and useful" test is a loaded standard that focuses retrospectively only on the consumer interest in receiving service at the lowest possible rate and not the range of other investor and consumer interests in the investment at issue. The "used and useful" test is therefore a one-dimensional and result-oriented ratemaking device that cannot override the balancing requirement of *Hope* and procedural safeguards required under *Permian*. *See Washington Gas Light Co. v. Baker*, 188 F.2d 11, 18-19 (D.C. Cir. 1950) (Bazelon, J.).

The Pennsylvania Supreme Court thus retrieved a ratemaking methodology from this Court's pre-*Hope* jurisprudence and gave that methodology a contemporary constitutional dimension. This decision results in a rate order that is unfair to utility investors, who invested their own funds in the design and engineering of four electrical generating units for the public benefit, and recovered *nothing* as compensation for this investment. Reversing the anachronistic approach taken by the Pennsylvania Supreme Court would serve to instruct state ratemakers, legislators and courts to be faithful to the balancing of interests mandated by *Hope* and *Permian*.

II. The PUC Orders Below Reflect A Balancing Of Investor and Consumer Interests.

In this case, the PUC adhered to its obligations under *Hope* and *Permian*. In each of the rate orders under review, the PUC adopted the reasoning and the end result recommended by Judge Matuschak in the *CAPCO Investigation*. Judge Matuschak had carefully balanced investor and consumer interests as contemplated by *Hope*, and had articulated his reasoning as required by *Permian*. This careful balance was destroyed by the Pennsylvania Supreme Court's unconstitutional interpretation of Act 335 and other unspecified Pennsylvania ratemaking legislation.

Just compensation is a principle of fairness.[18] The compensation of individuals for their investment that has been dedicated to public use involves a judgment as to what is fair under the circumstances of each particular case. Thus, in evaluating which factors are "pertinent" to the constitutionally mandated balancing of investor and consumer interests, ratemakers should be guided by "considerations of justness and fairness." *Natural Gas Pipeline*, 315 U.S. at 607 (Black, J. concurring).

Judge Matuschak was guided by these considerations. Before recommending that the Duquesne and Penn Power shareholders receive a return *of* their investment in the four CAPCO units, he surveyed the treatment of cancellation costs in other jurisdictions. This survey provided Judge Matuschak with a means

[18] *See generally*, Michelman, *Property, Utility and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165 (1967).

of articulating many of the investor and consumer interests pertinent to the balancing process required by *Hope* and *Permian* that he considered in reaching his decision.

For example, Judge Matuschak quoted from a decision of the Public Utility Commission of Texas, which recognized that permitting shareholders to recover their investment in cancelled plants "provides a necessary incentive for the utility to take reasonable investment risks for the benefit of ratepayers." (App. 11h). Judge Matuschak had before him the fact that the four plants at issue were planned and started at a time when electricity demand was rising steadily (App. 16h) and that the PUC itself had insisted upon the Pennsylvania utilities increasing their construction of new generating plants. Indeed, the investments at issue discharged the utilities' statutory duty to provide electric service to consumers. *See* 66 Pa.C.S. § 1501. Thus, the *consumer* interest in uninterrupted electric service was a pertinent factor that supported, if not mandated, incurring the costs at issue. It is only fair that if electric utilities are required by law and public policy to invest in generating capacity in the public interest, they should at least recover the cost of their investment.

Moreover, the changes in circumstances which forced the cancellation of the four CAPCO units were not reasonably foreseeable. Thus, another pertinent factor was the unfairness of requiring a utility to undertake an investment in the public interest and then retrospectively denying a recovery of that investment when unforeseeable circumstances cause it to be cancelled. Judge Matuschak recognized this fairness principle in quoting from a FERC decision involving the St. Rosalie plants.

(App. 12h). In that decision, FERC had rejected the notion that the cancelled plants necessarily represented a "mistake." Rather, FERC had found that the cancellations "simply resulted from a change of circumstances which could not reasonably have been foreseen." *Id.*

Judge Matuschak also considered the fact that the decision to invest in the preconstruction costs of the four CAPCO units, and each subsequent decision up to and including the decision to cancel the units, were reasonable and prudent. Simple fairness dictates that shareholders who have invested in the public interest should not be penalized when their investments have been found to be reasonable and prudent. Judge Matuschak quoted with approval from decisions of the Michigan, California and Maine commissions (App. 12h–14h), in which the commissions considered the reasonableness and prudence of the investment "[i]n an attempt to balance equitably the responsibility as between investors and consumers in connection with cancellation costs of abandoned plants. . . ." (App. 13h). He thus concluded that "the overwhelming weight of authority" supported "the principle that an expense prudently incurred, even for a project later cancelled or abandoned because of changed circumstances, is a proper expense for ratemaking purposes." (App. 11h).

The final factor that Judge Matuschak considered was the consumer's interest in not having to pay unreasonably for an investment that does not provide them with present electric service. Although he did not articulate this consumer interest as such, he accounted for it by way of his holding that Penn Power and Duquesne shareholders be denied a return *on* their investment.

All of these constitutionally pertinent factors were developed in the record before Judge Matuschak. Unburdened by Act 335, which had not been adopted, Judge Matuschak considered these factors and struck a balance. He permitted the shareholders to recover the amounts they had invested, without recovering interest or any other return *on* their investment during the recovery period. Under this approach the shareholders do not profit from their investment, but also are not forced to bear the risk of the entire loss. Judge Matuschak's recommendation, which was adopted by the PUC, thus represents "a proper balancing between investor and consumer interests." (App. 19h).

III. The Challenged Legislation Unconstitutionally Precludes the PUC From Considering Factors Pertinent To The Balance Between Investor and Consumer Interests

Historically, state ratemaking commissions were formed to relieve legislatures of the cumbersome task of setting rates by legislation. In delegating legislative tasks to a ratemaking agency, the legislature provides minimum standards to define the agency's duties and powers. On the other hand, where the ratemaking decisions of the agency can have constitutional implications for private parties, the agency must be invested with discretion sufficient to conform its decisions to constitutional mandates. The lesson of *Hope* and *Permian* is that rate orders must reflect a balance of investor and consumer interests in order to avoid a taking of property without just compensation. Consequently, a necessary corollary of the *Hope* balancing test is that a state ratemaking agency must possess under state law sufficient discretion within the boundaries of its ratemaking

authority to balance investor and consumer interests and thereby produce a constitutional end result. In short, *Hope* and *Permian* require that the one who sets rates must balance.[19]

In Pennsylvania, the one who sets rates, the PUC, is statutorily precluded, for the purpose of this case,[20] from balancing investor and consumer interests when considering a utility's investment in cancelled electric generating units. *Permian* requires that the ratemaking agency articulate "fully and carefully the methods by which, and the purposes for which, it has chosen to act," and assess the consequences of its action on the balance between investor and consumer interests. 390 U.S. at 792. As interpreted by the Pennsylvania Supreme Court, Act 335 and other unspecified Pennsylvania ratemaking legislation now permit consideration

[19]In concept, this principle is not unlike the familiar administrative law principle developed from notions of due process that "the one who decides must hear." *See Morgan v. United States*, 298 U.S. 468, 481 (1936).

[20]Because the cancellation date of the four CAPCO units fell within the bizarre gap between Act 335 and the subsequently enacted § 520, 66 Pa.C.S. § 520, the costs at issue in this case are the only investments in cancelled electric generating units that are barred by the Pennsylvania Supreme Court's interpretation of Act 335. Section 520 permits amortized recovery *of* (but not a return *on*) the prudently incurred costs of cancelled electric generating units. But § 520 applies by its terms only to cancellations effected after October 10, 1985, a date conveniently subsequent to the well-known January 22, 1980 cancellation date of the four CAPCO units. The arbitrary and irrational interplay between Act 335 and § 520, as well as the Pennsylvania Supreme Court's arbitrary and result-oriented "heads the consumer wins, tails the utilities lose" interpretive approach do not even satisfy the existing due process standards for testing state economic regulation under the Fourteenth Amendment. *See generally Nebbia v. New York*, 291 U.S. 502, 525 (1934) and its progeny (requiring that economic regulation not be arbitrary and irrational). *See also Permian*, 390 U.S. at 769–70. In addition, by enacting § 520, the Pennsylvania legislature has itself conceded that denial of the recovery *of* prudently incurred investment in cancelled electric generating units is not necessary to protect any constitutionally pertinent consumer interest.

of only *one* factor in determining whether to compensate Duquesne and Penn Power shareholders for their investment in the four CAPCO units: whether the units are providing present electric service to Duquesne and Penn Power consumers. This legislation, therefore, prevents the PUC from considering any other constitutionally pertinent factor, such as the fact that the investment by the Duquesne and Penn Power shareholders was undertaken to protect the consumer interest in receiving uninterrupted electric service, the fact that their investment was encouraged or required by state law, or the fact that their investment, though not resulting in a completed facility, was prudently made. In short, the Pennsylvania legislature has attempted through Act 335 and other unspecified ratemaking legislation to place its heavy finger selectively on the balance between investor and consumer interests without itself undertaking the full analysis of pertinent factors required by *Hope* and *Permian*.

The challenged legislation is facially invalid because it vests the PUC with the function of developing the constitutionally pertinent facts while simultaneously depriving the PUC of the capacity to consider such facts. Under these constraints, the PUC is incapable of framing a rate order that satisfies the *Hope* and *Permian* requirements. Moreover, the challenged legislation is invalid as applied, because, as Judge Matuschak recognized, the facts of this case establish strong investor and *consumer* interests that supported recovery *of* the shareholder's investment. Where the PUC is precluded from considering these interests, it is constrained to produce a rate order that does not reflect a balance of investor and consumer interests with respect to the

Duquesne and Penn Power investment in the four CAPCO units.

The challenged legislation should be invalidated, thereby reinstating the decisions of the PUC which conform to applicable constitutional standards.

IV. Return Of The Investment In The Four CAPCO Units Is Mandated As A Matter Of Law

Separate and apart from the PUC's rate orders having satisfied the *Hope* and *Permian* requirements, the challenged legislation should also be invalidated because it both frustrates the reasonable expectations of utility investors and prevents them from being compensated for their prudent investment dedicated to public use. The reasonable expectations of utility investors requires recovery, *per se*, *of* a utility's prudent investment in cancelled electric generating units. Recovery *of* their prudent investment is also necessary to ensure that utility investors are made whole on their investment dedicated to public use in satisfaction of the utility's duty to serve.

The unfairness of saddling a utility investor with risks he or she could not have expected underlies this Court's analysis in both *Hope* and *Permian*. This Court recognized that the extent to which a rate order will "fairly compensate investors for the risks they have assumed" is a pertinent factor to be considered in the balancing of investor and consumer interests. *Permian*, 390 U.S. at 792.[21] This Court has also considered

[21] The "balance" struck by Judge Mutuschak and the PUC below would not produce a complete economic retrieval of the utility shareholders' investment, because the denial of a return *on* the unamortized balances during the ten-year amortization period would take from the investors the

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whether governmental conduct interferes with "reasonable, investment-backed expectations" in determining whether a taking has occurred. *Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979).

Investor expectations concerning risk and reward must be viewed prospectively from the time of the investment, and in the context of the existing regulatory environment. A system of regulation that prohibits investor returns in excess of a "reasonable" return on the utility's investment creates an expectation that at least some of the risks of loss are shared with the consumer. The investors give up the opportunity to reap higher returns on their prudent investment and the freedom to pick and choose whom they serve in exchange for rates permitting a recovery of their prudent investment and a reasonable return thereon. One commentator has explained:

> In the early 1970's, when utilities first committed billions of dollars to the generating plants that are being completed (or cancelled) in the 1980's, they

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time value of their invested funds. The effect of this balance is to require the utility investors to provide consumers with what amounts to an interest-free loan. The economic consequence of lengthening the amortization period can be dramatic. During the *CAPCO Investigation*, Judge Matuschak recognized that Duquesne:

> has paid its costs in connection with the cancelled plants for the past eight years, and will continue to do so over the next ten years. The investors will pick up more than 50% of the associated costs even if the Company's claim [for recovery *of* such costs] is paid in full.

(App. 19h–20h). In light of this effect of the amortization period on the recovery *of* a utility shareholder's investment, it can be argued that utilities are constitutionally required to receive a return *on* the unamortized balance during the amortization period in order to enable them to receive a full recovery *of* their investment. This issue, however, is not presented in this appeal. Both Duquesne and Penn Power acquiesced in Judge Matuschak's balancing of interests in the *CAPCO Investigation* and neither utility presented a claim for a return *on* the unamortized balances in the rate proceedings at issue in this case. *See* note 8 *supra*.

> premised their investment decisions on a form of social contract with regulatory agencies. In that era, the rough contours of the social contract seemed reasonably well-settled and supported by a broad political consensus. The utility agreed to make a substantial investment and to forgo the opportunity to earn a supernormal return if the investment proved to be unusually good. In return, the utility expected the opportunity *to recover the full cost of its investment* and to earn a "normal" return even if the investment proved to be unusually bad. This expectation was subject only to the remote risk that regulators might find that the utility acted imprudently in making the investment.

Pierce, *A Proposal to Deregulate the Market for Bulk Power*, 71 VA. L. REV. 1183, 1200 (1986) (emphasis added). This sharing of risks has also been described as "a compact of sorts," *Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168, 1189 (D.C. Cir. 1987) (Starr, J., concurring), and "the substitute for the state in the performance of the public service." *Southwestern Bell*, 262 U.S. at 291 (Brandeis and Holmes, JJ., concurring).

Recovery *of* their investment thus is necessary, at minimum, "to compensate investors for the risks they have assumed."[22] *Permian, 390 U.S. at 792.* Where a regulatory system consistently permits recovery *of* a utility's prudent expenses, shareholders invest with the expectation that they will receive such a recovery. The rate of return they receive reflects the corresponding

[22] In his dissent in *Jersey Central Power v. FPC*, Judge Mikva explained how consideration of investor risks results in a rate order that strikes the same balance as the PUC struck below:

> In an unregulated environment, the customer would not be deemed a risk-taker. He invests no capital in the enterprise and therefore bears neither the upside nor the downside risk. The investors are the

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level of risk. *See Washington Gas Light*, 188 F.2d at 19. Where a state changes the governing rules *after* the investment is made so as to deny any recovery *of* prudent expenses, the investor is deprived of compensation, because he had not been receiving a return *on* his investment corresponding to the risk of nonrecovery and he is now deprived of his expected recovery *of* the out-of-pocket funds he has invested. *Cf. West Ohio Gas Co. v. Public Utilities Comm'n*, 294 U.S. 63, 67-71 (1935). When such compensation is denied, the resulting rates become unconstitutionally confiscatory.

A rate order is also confiscatory if it denies utility investors a recovery *of* their prudent investment made pursuant to the utility's statutory duty to serve. In his historic concurrence in *Southwestern Bell*, Justice Brandeis recognized that a utility investor has a constitutionally protected interest in his investment because that investment has been devoted to the public service.

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> risk-takers. Under price regulations, which affords the utility a "natural monopoly" on service, some of the risk at either end of the spectrum is shifted onto the ratepayer. The transfer, however, is not so dramatic as to relieve the stockholder of the entire risk of loss.
>
> Application of this principle is readily apparent in the Commission's current treatment of electric utility plants, investments prudent when made but sometimes frustrated in fruition. If the investment is successful, the customer benefits from controlled rates for the service provided. But the ratepayer also shares the costs if the investment fails; he must pay for the expenditure made on an unproductive facility from which he obtains no service. From the investor's viewpoint, price regulation cabins both his upside and downside risk. He cannot collect the windfall benefits if the project is a boon; he does not bear all costs if the project is a bust. Electric utility stockholders do not lose equity in the non-serviceable facility, as they might in the marketplace. They simply do not procure a return on the investment.

810 F.2d 1168 (D.C. Cir. 1987), at 1121-22 (Mikva, J., dissenting). Despite their widely divergent positions regarding whether the utility was entitled to a return *on* its amortized cancellation costs, none of the opinions in *Jersey Central* ever suggested that the utility was not entitled to a return *of* such costs.

262 U.S. at 292. An electric utility is unlike most other regulated or unregulated enterprises because it is required by law to provide continuous electric service to its customers regardless of the risks, while at the same time the rewards it is entitled to receive are tightly controlled by the PUC. Under these circumstances, fairness requires that where investors have made an investment for the benefit of the consumers and in furtherance of the utility's statutory obligation to serve, and their investment has been found to be reasonable and prudent, the shareholders must, at least, receive a recovery *of* their investment.

The Court's language in *Natural Gas Pipeline* suggests that capital investment loss is fully recoverable by amortization:

> Capital investment loss at the end of the life of a business can only be avoided by restoration of the investment from earnings, and is avoidable so far as is humanly possible only by an appropriate charge of amortization to earnings as they accrue.

315 U.S. at 594. *Hope's* treatment of depreciation costs, moreover, supports recovery *of* a utility's prudent investment.[23] In *Hope*, the utility challenged the basing of

[23]The balancing test of *Hope* focuses on claims of confiscation where a utility has received a smaller return *on* its investment than it had expected. *See e.g., Hope*, 320 U.S. at 603 ("the return to the equity owner should be commensurate with returns *on* investments in other enterprises having corresponding risks") (emphasis added). Moreover, the long controversy surrounding the proper ratemaking treatment of utility assets and investment focused on the return *on* the assets or investment of the utility. This controversy should not obscure the established consensus that the utility investor is entitled to, and therefore expects to, recover from the consumer all proper expenses, including a return *of* his investment through amortization or other charges to the operating expense account. In the pre-*Hope* era this Court permitted recovery of all "reasonable" expenses. *See, e.g., Lindheimer v. Illinois Bell Telephone Co.*, 292 U.S. 151 (1934); *Dayton Power &*

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annual depreciation charges on original cost. *Hope*, 320 U.S. at 606. In approving the Federal Power Commission's treatment of depreciation, this Court in *Hope* justified the new method because "by such a procedure the utility is made whole and the integrity of its investment maintained." *Id.*[24] *Hope* thus distinguished between a utility's return *of* its investment, for which it must be "made whole," and a utility's return *on* its investment, which must reflect a "balancing of the investor and the consumer interests." *Id.* at 603. This distinction suggests that utilities are entitled to more than simply a balancing of interests with respect to recovery *of* their prudent investment—they are entitled *per se* to such a recovery.[25]

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Light Co. v. Public Utilities Comm'n, 292 U.S. 290 (1934). Following *Hope*, as set forth in the text, this practice continued by way of permitting recovery of all "prudent" expenses.

The Pennsylvania Supreme Court (App. 24a) construed *Lindheimer* and *Dayton* as establishing a *per se* rule that expenses, such as those for engineering, forward planning and procurement, which do not provide "*present* utility service" are in effect not "reasonable" and hence are not recoverable. Neither case supports this result-oriented and illogical conclusion. The Pennsylvania Court, of course, could not and did not overturn the record finding of reasonableness and prudence. (App. 19b). Once one understands the distinction between the rate base and the operating expense account, *see* note 11, *supra*, there is no logical reason why disallowance of an item from rate base because it does not provide present utility service necessarily requires disallowance of the item from the operating expense account as well.

[24]This Court referred generally to the dissent of Justice Brandeis in *United Railways & Electric Co. v. West*, 280 U.S. 234, 259–288 (1930). 320 U.S. at 606 & n. 11. In *West*, Justice Brandeis, with Justices Holmes and Stone concurring, had objected to tying depreciation recovery to the fair value of particular assets, rather than treating depreciation as a return *of* the capital invested by the utility shareholders.

[25]Where a utility is denied a return *of* its investment, investors are forced to forfeit funds that they have invested from their own pockets. The distinction in *Hope* between return *of* and return *on* the utility shareholder's investment is analogous to the land-use area where physical invasion of property is treated under a higher standard than regulations that

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Since *Hope*, federal courts have recognized that utilities are entitled to recover amounts invested in prudently incurred expenses, including engineering expenses similar to those involved in this case. *See Mississippi River Fuel Corp. v. FPC*, 163 F.2d 433, 438 (D.C. Cir. 1947) (referring to engineering costs). The court in *Mississippi River Fuel* recognized that it was confiscatory for a ratemaking agency to deny recovery *of* prudently incurred expenses.[26]

Hope and *Permian* are grounded in the theories of utility ratemaking contained in J. BONBRIGHT, VALUATION OF PROPERTY (1937). Bonbright was at the forefront of developing the notion that a ratemaking agency need not employ any particular methodology, as long as the method employed is applied consistently. Bonbright was also aware that principles of "fair play" require that when changes are made to ratemaking

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merely diminish the expected value of an individual's property. *See, e.g., Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 435-38 (1982); *United States v. Causby*, 328 U.S. 256 (1946). *See generally, Keystone Bituminous Coal Assoc. v. DeBenedictis*, 107 S.Ct. 1232, 1244, n. 18 (1987). Denial of a recovery of a shareholder's investment, like a physical invasion, takes from a person something that was once physically in his possession, and thus rises to something more than merely "adjusting the benefits and burdens of economic life to promote the common good." *Penn Central Transportation Co. v. New York City*, 438 U.S. 104, 124 (1978). In contrast, denial of a return *on* investment, like a regulatory land-use taking, interferes with the expected value of an individual's property. Recovery *of* prudently incurred costs is thus deserving of protection *per se*.

[26] As the District of Columbia Circuit recognized in *Mississippi River Fuel*:

> Expenses (using that term in its broad sense to include not only operating expenses but depreciation and taxes) are facts. They are to be ascertained, not created, by the regulatory authorities. If properly incurred, they must be allowed as part of the composition of the rates. Otherwise, the so-called allowance of a return upon the investment, being an amount over and above expenses, would be a farce.

163 F. 2d at 437.

methodologies the costs borne and rewards received by investors and consumers be related to their expectations and the risks they have assumed. *See* 2 J. BONBRIGHT, VALUATION OF PROPERTY at 1155 & n.113 (1937).

The Pennsylvania Supreme Court's decision in this case does violence to the reasonable expectations of utility investors by applying a statutory standard that was not in existence and could not have been anticipated when they made their prudent investment in the four CAPCO units. This decision saddles the investors of Duquesne and Penn Power with risks that they did not voluntarily assume, and denies them *any* compensation for their prudent investment in the design and engineering of four electrical generating units that were undertaken pursuant to a public duty. Denial of any recovery *of* the costs prudently invested in the four CAPCO units effects an unconstitutional taking of the investors' property.

CONCLUSION

This Court should reverse the judgment below, thereby reinstating the decisions of the PUC which conformed to applicable constitutional standards.

Respectfully submitted,

ALAN L. REED
WILLIAM E. ZEITER*
JOHN F. STILLMUN, III

MORGAN, LEWIS & BOCKIUS
2000 One Logan Square
Philadelphia, PA 19103
(215) 963-5367

CHRISTINE A. HANSEN
RICHARD S. CHRISTNER
LARRY R. CRAYNE
DUQUESNE LIGHT COMPANY
1 Oxford Centre
301 Grant Street
Pittsburgh, PA 15279

JAMES R. EDGERLY
STEPHEN L. FELD
PENNSYLVANIA POWER COMPANY
1 East Washington Street
New Castle, PA 16103-0891

Attorneys for Duquesne Light Company and Pennsylvania Power Company

*Counsel of Record

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No. 87-1160

In the Supreme Court of the United States

October Term, 1987

DUQUESNE LIGHT COMPANY
and
PENNSYLVANIA POWER COMPANY,
Appellants

v.

DAVID M. BARASCH,
CONSUMER ADVOCATE, et al.,
Appellees

ON APPEAL FROM THE SUPREME COURT OF PENNSYLVANIA

BRIEF FOR APPELLEE, PENNSYLVANIA PUBLIC UTILITY COMMISSION

DANIEL P. DELANEY
Chief Counsel
BOHDAN R. PANKIW*
Deputy Chief Counsel
JOHN A. LEVIN
Assistant Counsel
Attorneys for Appellee, Pennsylvania Public Utility Commission

Commonwealth of Pennsylvania
Pennsylvania Public Utility Commission
P.O. Box 3265
Harrisburg, PA 17120
(717) 787-5000

June 30, 1988

*Counsel of Record

57 pp

QUESTIONS PRESENTED

1. Whether Act 335, which mandates that the Pennsylvania Public Utility Commission exclude the cost of construction from consumer rates until the facilities provide service to the public, is unconstitutional on its face?

2. Whether the application of Act 335 to the electric companies' cancelled plant costs would result in rate orders whose total effect represent an unconstitutional taking of property in violation of the Fifth and Fourteenth Amendments to the United States Constitution?

3. Whether this Court should adopt a risk-free prudent investment theory as the constitutional standard applicable to public utility rate regulation, thereby insulating public utilities from most business risks and overruling *Hope Natural Gas* and *Permian Basin*?

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In the Supreme Court of the United States

October Term, 1987

No. 87-1160

DUQUESNE LIGHT COMPANY
and
PENNSYLVANIA POWER COMPANY,
Appellants

v.

DAVID M. BARASCH,
CONSUMER ADVOCATE, et al.,
Appellees

ON APPEAL FROM THE SUPREME COURT OF PENNSYLVANIA

BRIEF FOR APPELLEE, PENNSYLVANIA PUBLIC UTILITY COMMISSION

CONSTITUTIONAL AND STATUTORY PROVISIONS

United States Constitution, Amendment V, clause 4:

> [N]or shall private property be taken for public use, without just compensation.

United States Constitution, Amendment XIV, clause 3:

> [N]or shall any State deprive any person of . . . property, without due process of law . . .

Constitution of the Commonwealth of Pennsylvania, Article 1, Section 10, clause 3:

[N]or shall private property be taken or applied to public use, without authority of law and without just compensation being first made or secured.

Pennsylvania Public Utility Code:

66 Pa. C. S. §§101 et seq.
66 Pa. C. S. §1315 ("Act 335")

STATEMENT OF THE CASE

This is an appeal by two electric utilities ("the electric companies") of a decision of the Supreme Court of Pennsylvania interpreting an act of the Pennsylvania Legislature (Act effective December 30, 1982, Act No. 1982-335, P.L. 1473, 66 Pa. C. S. §1315) ("Act 335") (App. 23L-24L)[1] and Chapter 13 of the Pennsylvania Public Utility Code, 66 Pa. C. S. §§1301-1325 (App. 1L-39L).

The Pennsylvania Public Utility Commission is an arm of the legislature, and its powers are derived from the legislature. To determine what public policy shall be with respect to the regulation of public utilities is the ultimate prerogative of the legislature and not of the Public Utility Commission. *Bell Telephone Company of Pennsylvania v. Driscoll, et al.*, 343 Pa. 109, 21 A.2d 912 (1941), *City of Philadelphia v. Philadelphia Electric Co.*, 504 Pa. 312, 473 A.2d 997 (1984). It is the duty of the Pennsylvania Public Utility Commission to enforce the Public Utility Code. 66 Pa. C. S. §501.

On January 28, 1983, the Commission issued a decision on a general rate increase filing by Duquesne Light Company ("Duquesne") which granted an "increase in operating revenue of $105,850,000 or approximately 64 percent of the $165 million increase requested." (App. 126c) On April 11, 1984, the Commission issued a similar decision on a general rate increase filing made by Pennsylvania Power Company ("Penn Power")

[1] By order dated April 18, 1988, this Court granted Appellants' Motion to Dispense with Printing of the Joint Appendix. All references to "App." are to the Appellants' Appendix to Jurisdictional Statement.

granting "an increase in annual electric base rate operating revenue of approximately $15,364,000 . . . or approximately 77 percent of the requested base rate increase of $19,890,200." (App. 110e) In both orders, the Commission approved, on the basis of an earlier determination made in its Order in the CAPCO investigation (App. 1h, 1i) that both companies would be permitted to recover, over a ten year period, a return *of*, but no return *on* the prudently incurred costs associated with planning for four nuclear power plants that were cancelled by the electric companies on January 23, 1980 (App. 8h).

These decisions were appealed to the Commonwealth Court of Pennsylvania by the Consumer Advocate of Pennsylvania, an appellee in this proceeding. The Commonwealth Court of Pennsylvania, three of its members dissenting, sustained the rate orders (App. 1b) against an attack based upon an interpretation of a newly enacted statute, Act 335 (App. 23L-24L). The Supreme Court of Pennsylvania reversed in an order entered October 15, 1987 (App. 1a). Basing its decision upon provisions of the United States Constitution, the Pennsylvania Constitution and an interpretation of the Pennsylvania Public Utility Code, the Supreme Court of Pennsylvania held that the Pennsylvania Public Utility Commission had no power to issue a rate order which allows utilities to receive compensation through utility rates for property that is not "used and useful" in the public service.

On January 7, 1988, the electric companies filed a notice of appeal in the Supreme Court of Pennsylvania. Your Court noted probable jurisdiction on March 7, 1988.

SUMMARY OF ARGUMENT

This case involves the fundamental constitutional standard for reviewing public utility ratemaking orders established in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) and *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968). Those landmark cases hold that rates which effectively

balance investor and consumer interests, measured with regard to the total effect of the rate order, are constitutionally permissible regardless of the particular ratemaking methods or elements used to achieve that "end result." In so holding, *Hope Natural Gas* and *Permian Basin* shifted the focus of the constitutional analysis from the valuation of specific assets to the total effect of the rate order on the capital invested in the enterprise.

The challenge to Act 335 raised by the electric companies fails to establish that the denial of cancelled plant costs in this case results in an unconstitutional taking of its property. Act 335 on its face applies to many potential situations where the compelling consumer interest in not paying for idle or partially completed facilities clearly outweighs the investor interest in a recovery of all expenditures and capital costs from consumers. As applied, Act 335 pertains to a relatively minor portion of the rate base of Duquesne Light Company and Pennsylvania Power Company and reduces the revenue of each by less than one percent.

The Pennsylvania Public Utility Commission, here appearing as appellee, originally issued orders in 1983 and 1984 which allowed recovery of the cancelled plant costs which are the subject of this appeal. It did so on the basis of what it perceived to be its discretion to regulate Pennsylvania utilities so as to secure "adequate, efficient, safe and reasonable service"[2] at "just and reasonable rates".[3] The Commission's judgment was partly based upon a view that it was beneficial from the standpoint of public policy to encourage utilities to cancel unnecessary construction and that allowing utilities to amortize the costs of such failed projects over a period of years would best achieve that result (App. 14d). As an administrative agency created by the legislature with only such powers as are delegated to it by the legislature, this Commission recognizes that the legislature may dictate what policy shall be adopted which touches upon the

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[2] 66 Pa. C. S. §1501.

[3] 66 Pa. C. S. §1301.

public interest. This case is brought to your Court by direct appeal pursuant to 28 U.S.C. §1257(2) from a decision of the Supreme Court of Pennsylvania. Inasmuch as that decision is independently grounded in the Constitution of the Commonwealth of Pennsylvania and in the laws of Pennsylvania the order below should be affirmed, or this appeal be dismissed for want of a substantial federal question. Pa. Const. Art. 1, §10, *National Wood Preservers, Inc. v. Commonwealth of Pennsylvania, etc.*, 489 Pa. 221, 414 A.2d 37 (1980), *appeal dismissed*, 449 U.S. 803, *Herb v. Pitcairn*, 324 U.S. 117, 125 (1945).

A. The Facial Attack Upon the Pennsylvania Public Utility Code

This case represents the first general attack in many years on the constitutional standard applicable to state utility ratemaking determinations. After *Hope Natural Gas* ended a fifty-year search for the philosopher's stone of constitutional rate regulation, rate regulation turned from a war of competing economic theories to a rational allocation of costs and risks between investors and consumers. The electric companies in this appeal ask that state legislation prohibiting the recovery of the costs of utility facilities which never become used and useful in the public service be found a *per se* violation of the Fifth Amendment prohibition against the taking of property without just compensation. The position of the electric companies is that the Pennsylvania General Assembly has no power to pass legislation which allocates the risks of the utility business to the utility and its investors. Instead, argue the electric companies, only the Pennsylvania Public Utility Commission can decide that, and only then on an *ad hoc* basis. The electric companies argue that state legislatures have no business deciding such policy matters. These arguments cannot be sustained.

The electric companies, by asking that Act 335 and the Pennsylvania Utility Code be struck down based upon their theoretical disagreement with the "used and useful" standard are making a "substantive due process" attack against a state

regulatory statute of a kind common in the days following *Lochner v. New York*, 198 U.S. 45 (1905). Such attacks were discredited in *Nebbia v. New York*, 291 U.S. 502 (1934). Substantive due process attacks against state economic regulation have been repudiated by your Court. *Ferguson v. Skrupa*, 372 U.S. 726, 729-31 (1963).

The facial attack is also invalid because the electric companies have failed to make the necessary showing that the "used and useful" rule is unconstitutional in all its applications. Moreover, the appellants have failed to demonstrate that it is unconstitutional as applied to the denial of the inclusion of cancelled plant costs in utility rate base for ratemaking purposes. Finally, the electric companies have not attempted to demonstrate that they have suffered any constitutional harm or deprivation of "investement backed" expectations by reason of the interpretation of the Pennsylvania Public Utility Code by the Supreme Court of Pennsylvania.

Board of Regents v. Roth, 408 U.S. 564 (1972) established the principle that one asserting the unlawful deprivation of a protected Fifth Amendment property interest must first establish the independent legal existence of such property interest or a reasonable expectation of such property interest. The electric companies in this case have failed to establish that the Commonwealth of Pennsylvania ever created a legal right or a reasonable expectation that the electric companies might charge their ratepayers for the costs of failed projects which are never devoted to the public service. Numerous state cases through the years testify to the continuing vitality of the "used and useful" rule, and that the rule serves to advance valid state interests in utility rate regulation.

The electric companies' radical suggestion that the United States Constitution requires the adoption of the "prudent investment" rule would force utility ratepayers to bear the business risks undertaken by the utilities and their shareholders. That position is clearly contrary to the doctrines of *Hope Natural Gas* and *Permian Basin* since "regulation does not insure that the business shall produce net revenues." The position, if adopted, would shift all of the risks of doing business from utility investors (who already earn a return which includes consideration for such risks) to utility ratepayers.[4] The facial attack is invalid and should be rejected.

B. The Attack Upon the Pennsylvania Public Utility Code as Applied

The electric companies have misstated the standard for constitutional analysis of a state order alleged to be confiscatory. *Hope Natural Gas* holds that rate orders must balance investor and consumer interests with respect to the *total* impact of the rate order. The electric companies have failed to demonstrate on this record that the total effect of the challenged rate orders, as modified by the "used and useful" rule will have any significant adverse impact on investor interests. The evidence indicates that no such harm can be established. Without a demonstration that "investor interests" are damaged, appellants have failed to make even a preliminary showing under *Hope Natural Gas* that an improper balancing of investor and consumer interests has been struck by the decision of the Supreme Court of Pennsylvania and this appeal must be dismissed.

Hope Natural Gas has shifted the focus of Constitutional inquiry from the valuation of specific assets to the rate order's total impact upon the capital invested in the enterprise. Although the electric companies recognize this fundamental shift in focus, they nevertheless challenge a state statute that affects only a relatively minor portion of the assets they seek to include

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[4] This facial attack implicates a broad range of public utility ratemaking determinations. Ratemaking determinations which could be affected by this case include the proper ratemaking treatment of excess generating capacity, construction work in progress, public utility plant (otherwise prudently constructed) idled by utility imprudence or ordinary business risk, and unusual or non-recurring expenses. These matters are frequent concerns of State utility ratemakers and State legislatures, and have been resolved in a variety of ways.

in their rate bases. The electric companies have not and cannot demonstrate on this record that the total effect of a rate order which disallows recovery of cancelled plant costs will fail to balance effectively investor and consumer interests. The electric utility investors were compensated in this case in the allowed rate of return for the risks associated with the utility business, including the risk that investors would receive no compensation for failed projects undertaken by the utility.

Additionally, the electric companies fail to demonstrate that they had any reasonable expectation in the recovery of all costs associated with plant that is never devoted to the public service. Act 335 serves to advance important state interests and is a valid exercise of the state police power. The constitution does not require that the state make utilities whole for competitive losses or for losses associated with the risks of the business.

C. The Invitation of the *Amici Curiae* To Adopt a Risk-Free "Prudent Investment" Rule

The arguments of the *amici curiae* also represent a radical departure from existing law. The Edison Electric Institute ("EEI") argues that *Hope Natural Gas* forbids the use of the "used and useful" formula which has been applied by the majority of states for the last 50 years. EEI goes on to argue that all prudent investment should be included in utility rate base for ratemaking purposes. That argument substantially enlarges the scope of this case which is limited on its facts to prudently initiated utility construction which is cancelled before completion. EEI would have the Court *forbid* the use of the "used and useful" standard and obligate ratepayers to pay a return upon obsolete, destroyed, redundant or uneconomic utility plant.

The Pennsylvania Electric Association ("PEA") denies that the Commonwealth of Pennsylvania has any legitimate interest in allocating the business risk of construction to utilities. PEA urges the Court to adopt its version of the "prudent investment" model as the standard of constitutional ratemaking for the fifty

states, essentially asking the Court to overrule *Hope Natural Gas*.

Adoption of the "prudent investment" rule would not be a panacea or reduce regulatory litigation as is suggested. Instead it would embroil the state and federal courts in an explosion of litigation over what constitutes constitutional "prudency" and "prudent investment." Moreover, it would completely ignore the substantial and legitimate consumer interest in not paying through utility rates for the costs of idle or excess capacity facilities. The balance struck by the *Hope Natural Gas* decision would be destroyed.

The Constitution does not embrace any particular economic theory or regulatory model nor does a constitutional challenge obligate your Court to decide between competing economic models.[5] There is no reason to believe that an asset-based Constitutional analysis of rate regulation, having failed of satisfactory application in the first half of the 20th century, can now succeed. The electric companies would have this Court prohibit state legislatures from legislating in areas that are located in the heart of the exercise of the police power secured to the states by the Tenth Amendment to the United States Constitution. That is an economic "substantive due process" argument rejected by this Court.

This case is particularly inappropriate for the Constitutional reinterpretation requested by the electric companies and *amici curiae*, since the facts demonstrate that the appellants have suffered little actual economic harm from the legislation

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[5] As Mr. Justice Holmes stated in his dissent to *Lochner v. New York*, 198 U.S. 45 (1905), "This case is decided upon an economic theory which a large part of the country does not entertain . . . The Fourteenth Amendment does not enact Mr. Herbert Spencer's *Social Statics*." That dissent has now become part of the Constitutional standard for review of the regulatory legislation of the States, *North Dakota State Board of Pharmacy v. Snyder's Drug Stores, Inc.*, 414 U.S. 156 (1973); *Harper et al. v. Virginia State Board of Elections*, 383 U.S. 663 (1966).

they facially attack. The Pennsylvania Public Utility Commission respectfully submits that the electric companies have established no harm amounting to a deprivation of property without due process or without just compensation. This case represents an unsuitable basis for the radical revision of the constitutional law of state public utility rate regulation. The decision of the Supreme Court of Pennsylvania rests upon independent state constitutional and statutory grounds and should be affirmed.

ARGUMENT

I. The Appellants' Facial Attack Upon the Pennsylvania Public Utility Code Is Invalid

The regulation of public utility rates is one of the oldest forms of exercise of the police power. *Munn v. Illinois*, 94 U.S. 113, 125 (1877). With the growth of utilities in the latter half of the 19th century came the historical experience that such monopolies, unchecked, inevitably abuse their economic power by "setting exorbitant rates, discriminating among customers, and engaging in predatory behavior not only against the public but against each other."[6] The lessons of the first half of the 20th century were that judicial attempts to prescribe detailed constitutional ratemaking procedures inevitably resulted in failure. From the initial attempt in *Smyth v. Ames*, 169 U.S. 466 (1898) until the landmark case of *Hope Natural Gas* in 1944, your Court struggled with utility ratemaking by prescribing ratemaking formulas, independently reviewing evidence, and weighing competing economic theories.

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[6] Siegel, *Understanding the Lochner Era: Lessons from the Controversy over Railroad and Utility Rate Regulation*, 70 Va. L. Rev. 187 (1984).

A. A facial attack must be judged by the rules of standing.

It is a well settled principle of constitutional standing that a party asserting the invalidity of an enactment must assert its own claims, and not those of others. A facial attack is a claim that the "statute is invalid *in toto*—and therefore incapable of any valid application . . ." *Steffel v. Thompson*, 415 U.S. 452, 474 (1974).

A facial attack upon a statute or statutory scheme fails unless the challenger can establish that the enactment cannot be constitutionally applied in any conceivable manner.[7] Moreover, where an appellant launches a generalized attack against a statute based upon facts which apply to only one of the many possible situations, jurisdiction will not be exercised unless the case "tenders the underlying constitutional issues in clean-cut and concrete form." *Socialist Labor Party v. Gilligan*, 406 U.S. 583, 588 (1972) (quoting *Rescue Army v. Municipal Court*, 331 U.S. 549 (1947)). The reason for the principle is clear. Constitutional issues should not be decided in a vacuum lest they be decided wrongly. Invalidation of a statute which may be constitutionally applied does violence to the appellate process.[8] Similarly, a facial attack is invalid if the challenged statute can be constitutionally applied to the challenger[9] or if the challenger cannot show that the statute has actually deprived him of a constitutionally protected interest.[10]

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[7] Another ground may be that the statute is impermissibly vague, or overbroad in a manner that chills the exercise of protected rights. *Village of Hoffman Estates v. The Flipside, Hoffman Estates, Inc.*, 455 U.S. 489, 495-504 (1982). There is no such claim by the appellants in this case.

[8] *See generally*, Sedler, *The Assertion of Constitutional Jus Tertii: A Substantive Approach*, 70 Calif. Law Rev. 1308 (1982).

[9] *Village of Hoffman Estates v. The Flipside, Hoffman Estates, Inc.*, 455 U.S. 489 (1982).

[10] *See Schlesinger v. Reservists Committee to Stop the War*, 418 U.S. 208, 221-223 (1974). In *Schlesinger*, your Court found that taxpayers had no standing to assert that the Incompatibility Clause (U.S. Const.

B. The electric companies have no standing to make a facial attack against the Public Utility Code.

Duquesne and Penn Power's facial challenge to Act 335 and the Pennsylvania Public Utility Code as interpreted by the Pennsylvania Supreme Court is invalid because the appellants have not demonstrated that the statutory scheme is incapable of Constitutional application. The statute would apply to more than the single factual situation the appellants have presented to this Court.

Duquesne and Penn Power's facial challenge is invalid because the appellants have not demonstrated that the statutory scheme under attack, applied to the rate treatment of cancelled plant costs, facially works an unconstitutional deprivation of property without due process or without compensation.

Finally, the facial challenge is invalid because the appellants have failed to demonstrate upon the facts of this case that either of them has suffered any unconstitutional deprivation of property without due process or without compensation.

Two recent cases illustrate the burden an appellant must meet before initiating a facial attack upon a regulatory statute under the Takings Clause.

In *Pennell v. City of San Jose,* U.S. , 108 S.Ct. 849 (1988) the facial attack failed because the appellants could not show that the challenged ordinance was incapable of being constitutionally applied, and additionally because the landlords could not show that they had suffered harm amounting to a deprivation of a constitutionally secured right. The landlord's association challenged a rent control ordinance of the City of San Jose on the grounds that it included a provision requiring that

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Art. 1, §6, cl. 2, 8) prohibits Members of Congress from holding reserve officer commissions in the United States Armed Forces. Your Court held that a basic requirement of constitutional adjudication is that a party asking for such relief demonstrate concrete injury and a discrete factual context for relief. Mere desire to obtain sweeping relief is not enough.

its rent control hearing officers consider whether the effect of a proposed rent increase would constitute an unreasonably severe financial or economic hardship on a particular tenant. If so, the hearing officer was empowered to disallow such increase or any part thereof. The landlords' association's challenge was held to be premature.

It was held that there was a valid state interest in protecting tenants from severe economic hardship. Your Court emphasized the important state interest in rate regulation of monopoly businesses. Citing *Permian Basin*, 390 U.S. 747, 769-70 (1968) and quoting *Nebbia v. New York*, 291 U.S. 502, 539 (1934), your Court held that price control is unconstitutional only if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt, and that the challenged ordinance was facially in accord with the powers of the City of San Jose.

In *Hodel v. Virginia Surface Mining and Reclamation Association, Inc.*, 452 U.S. 264, 294-96 (1981) a facial challenge to a statute regulating coal mining operations which arose under the Takings Clause was rejected because of the absence of a factual situation which made a constitutional analysis necessary. The test applied to that facial challenge was whether the statute denied "an owner economically viable use of his land." Although there might be circumstances where the mining regulations might impose costs which would make mining prohibitive, your Court concluded that there are clearly other economically viable uses for properties affected by the act.[11]

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[11] *Hodel*, and other cases involving state regulation of, or intrusion upon real estate should be distinguished as involving a property interest which your Court has recently held to be fundamental. *Hodel* involved a regulation affecting the use of specific land or other property, rather than the regulation of rates. *Kaiser Aetna v. United States*, 444 U.S. 164 (1979), *Keystone Bituminous Coal Association v. DeBenedictis*, U.S. , 107 S.Ct. 1232 (1987), *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 (1982), *Penn Central Transportation Co. v. New York City*, 438 U.S. 104 (1978) and *United States v. Causby*, 328 U.S. 256

Taken together, the cases illustrate that a facial attack upon a statute which regulated rates or prices must fail unless it is predicated upon an actual application of the statute to the challenger which deprives the challenger of a constitutionally protected interest, and further, that the facts clearly illustrate that the statute cannot be constitutionally applied in any other manner. The instant facial challenge fails because, although the statute *has* been applied to the Appellants, they have not been deprived of any constitutionally protected interest, nor has it been shown that the statute is unconstitutional in all its applications.

The appellants claim that their facial attack upon Act 335 must include an attack upon the entire ratemaking chapter of the Pennsylvania Public Utility Code, 66 Pa. C. S. §§1301-1325 (App. 11-391)[12] because the Supreme Court of Pennsylvania held that the prohibition of Act 335 merely restated existing law with regard to "used and useful" plant and that other types of utilities are equally prohibited from recovering those costs associated with cancelled plants through utility rates.

The specific language of Section 1315 which is the basis of this appeal is as follows:

> Except for such nonrevenue producing, nonexpense reducing investments as may be reasonably shown to be necessary to improve environmental conditions at existing facilities or improve safety at existing facilities or as may

(1946) cited by appellants in their footnote 25, as well as *Nollan v. California Coastal Commission,* U.S. , 107 S.Ct. 3141 (1987), cited by *amici* EEI and PEA also involved regulation of the use of specific land or property. As the instant appeal involves economic regulation, the degree of regulation approved in the above cases is *a fortiori* permissible in the sphere of economic regulation.

[12] It is not immediately apparent whether the appellants also seek to challenge laws enacted subsequent to 1982 which amend Chapter 13 of the Pennsylvania Public Utility Code. 66 Pa. C. S. §§1316-1325 were enacted subsequent to 1982. Sections 1302, 1307, 1308 and 1311 were amended subsequent to 1982.

> be required to convert facilities to the utilization of coal, the cost of construction or expansion of a facility undertaken by a public utility producing, generating, transmitting, distributing or furnishing electricity shall not be made a part of the rate base nor otherwise included in the rates charged by the electric utility until such time as the facility is used and useful in service to the public. Except as stated in this section, no electric property shall be deemed used and useful until it is presently providing utility service to the customers.

66 Pa. C. S. §1315.

As interpreted by the Supreme Court of Pennsylvania, this language merely restates and reconfirms existing Pennsylvania law, which is that:

> [N]o utility of any type is permitted, without express and valid legislative authorization, to charge ratepayers for property which is not used and useful in the production of current utility service.

Barasch v. Pennsylvania Public Utility Commission, 516 Pa. 142, 532 A.2d 325, 338 (1987) (App. 28a-29a).

Although the facts of this case apply specifically to the exclusion from rate base of prudently initiated generating plant construction which is prudently cancelled on a timely basis, it is apparent that the appeal here seeks to challenge any application of the "used and useful" rule as unconstitutional. The "used and useful" rule applies to six situations in which the police power of the state is strongly implicated. In the following discussion "plant" refers to any capital asset that might be claimed in a utility's rate base, that is, an asset with a life of more than one year.[13]

[13] Expenditures for goods or services which have a service life of less than one year are considered expenses for ratemaking purposes.

The situations include:

—Prudently initiated, prudently cancelled construction. This situation is represented by the instant appeal.

—Imprudently initiated construction. This would include plant that was imprudently initiated or constructed and which was either later cancelled prior to completion, or actually completed despite a lack of need for such plant. Typical of such imprudent construction might be a large generating plant initiated without an adequate load forecast, or a transmission line which is imprudently oversized for the area which it would serve.

—Imprudently cancelled construction. Such projects might be initiated pursuant to prudently conducted studies, but which cannot be completed due to imprudent utility management, such as incompetent management of construction costs, failure to obtain continued financing, or loss of necessary permits due to violation of safety or environmental laws.

—Plant not used to provide utility service. This plant might include imprudently constructed excess capacity, plant used to provide non-utility, non-regulated service (e.g.: a utility owned coal mine which provides coal at a higher than market rate), or such obviously imprudent expenditures as valuable paintings or artwork, aircraft not used for utility business related travel, or other lavish or extravagant expenditures of a capital nature.

—Plant that is obsolete, inefficient or surplus. Such plant would include clearly obsolete or inefficient plant, plant not currently providing service and with no reasonable prospect of providing such service, or plant which cannot be operated due to physical deterioration, damage or destruction or plant which is idled due to health, safety or environmental prohibitions.

—Plant still under construction, but not yet completed. Pennsylvania currently permits utilities to claim some

plant (denoted as construction work in progress or CWIP) in rate base under statutorily defined conditions. Ordinarily, however, the utility is required to book its financing costs in a regulatory account and such costs are added to rate base at the time such plant goes into service. This provision is known as 'allowances for funds used during construction', or AFUDC, for electric utilities. The states are split on whether CWIP or AFUDC is the preferred method for accounting for the capital costs of plant under construction. *See generally,* C. F. Phillips, Jr., *The Regulation of Public Utilities,* 322-325 (1984).[14]

C. The electric companies have not addressed all applications of the statutes they attack.

The appellants' facial attack fails because they have not demonstrated that all applications of the Public Utility Code's prohibition against charging ratepayers for the cost of plant not "used and useful" violates the constitutional prohibitions of the Takings Clause of the Fifth Amendment to the United States Constitution.

In order to do so, the Appellants would have had to demonstrate that utilities have a reasonable expectation for recovery of the cost of investment that would be denominated as not "used and useful" in each of the above situations. *Board of Regents v. Roth,* 408 U.S. 564 (1972) rejects the idea that one asserting the unlawful deprivation of a protected Fifth Amendment property interest may do so on the mere basis of a desire to have a hearing on the issue without first demonstrating an

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[14] It should be noted that the "prudent investment" rule, offered as a substitute by the appellants and *amici* would facially seem to allow exclusion of plant that was imprudent when built or purchased. Proving imprudency is a difficult undertaking in even the most blatant situation and is productive of complex and protracted litigation. It is rational for the legislature to conclude that the public interest may well be better served by a clear, easily applied rule that provides a clear warning to utility managers and investors that the utility bears the risk of the business, not the public.

independent source of law or agreement creating the property interest. The electric companies' facial attack against the Pennsylvania Public Utility Code is essentially a "substantive due process" attack against state economic regulation.

D. The facial attack is an invalid economic substantive due process attack.

The electric companies, by asking that the Pennsylvania Utility Code be struck down based upon their disagreement with the "used and useful" standard are making a "substantive due process" attack against a state regulatory statute of a kind common in the days following *Lochner v. New York*, 198 U.S. 45 (1905) which has been repudiated by your Court. *Ferguson v. Skrupa*, 372 U.S. 726, 729-31 at n. 8 (1963). It is no longer acceptable to submit an alternative economic theory as the basis of a demonstration of the lack of wisdom of a state statute and then assert that the United States Constitution has been therefore violated. States "have power to legislate against what are found to be injurious practices in their internal commercial and business affairs, so long as their laws do not run afoul of some specific federal constitutional prohibition, or of some valid federal law." *Ferguson*, at 730-31 (citing *Lincoln Federal Labor Union, etc. v. Northwestern Iron & Metal Co.*, 335 U.S. 525, 536 (1949)). As further explained in *New Orleans v. Dukes*, 427 U.S. 297, 304 (1976):

> States are accorded wide latitude in the regulation of their local economies under their police powers, and rational distinctions may be made with substantially less than mathematical exactitude . . . the judiciary may not sit as a superlegislature to judge the wisdom or desirability of legislative policy determinations made in areas that neither affect fundamental rights nor proceed along suspect lines[.]

E. The electric companies have not demonstrated the independent existence of a property right to recover cancellation costs through public utility rates.

A person claiming the protection of the takings clause must first establish the independent legal existence of such property interest or a reasonable expectation of such property interest. The electric companies in this case have failed to establish that the Commonwealth of Pennsylvania ever created a legal right or a reasonable expectation that the electric companies might charge their ratepayers for the costs of failed projects which are never devoted to the public service. The history of Pennsylvania rate regulation demonstrates quite the opposite. Without the existence of such right or expectation, the electric companies cannot invoke the Takings Clause of the U.S. Constitution and this appeal must be dismissed.

"A mere unilateral expectation or an abstract need is not a property interest entitled to protection." *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 161 (1980), *Kaiser Aetna v. United States*, 444 U.S. 164, 179 (1979). The electric companies have attempted to create a property right in cancelled plant costs by citing a 1972 Pennsylvania Public Utility Commission Investigation order, *Investigation of the Need for Additional Electric Generating and Transmission Facilities; Investigation Docket No. 138*, 46 Pa. P.U.C. 23 (1972) (hereinafter *"I.D. 138"*). Yet a reading of that order reveals that the Pennsylvania Public Utility Commission did not announce that it was generally abandoning the "used and useful" rule, nor did it order Duquesne Light Company or Pennsylvania Power Company (or any other utility) to construct additional facilities. What the Commission actually said was:

> The Commission is now concerned about whether current plans are satisfactory to meet projected future needs for electric power. At the same time, the Commission is aware of two possible changes in conditions which

may affect the demands for electric power during the next several decades:

> 1. A developing trend to conserve the use of electric service and a moratorium on the promotion of total electric residential living units.
>
> 2. Environmental regulation at both federal and state levels could limit the ability of the electric utility industry to meet forecasted demands for power.

It is incumbent upon the Commission to determine whether or not an electric energy shortage will develop and have an adverse affect upon the electric utility industry or if the industry's construction program calls for excessive capital investment at the expense of existing rate paying customers. It is hypothetical that such programs will attract prospective customers who may be denied energy from gas suppliers and further distort the demand for power.

I.D. 138, at 25-26.

Accordingly the Commission ordered that Pennsylvania electric companies file annual statements of generating capacity, customer demand, forecasts of load growth, schedule of projected additions, existing generating plants, pollution abatement facilities construction costs, operating costs and filings of F.P.C. Form 12. No other formal action was taken by the Commission in connection with this investigation. Nowhere in that order did the Commission mandate that the electric utilities build the four large scale nuclear power plants that were later cancelled. Nowhere in that order did the Commission announce that utility investors would be relieved from the risks of the utility business.

By contrast, the Commission continued to apply the "used and useful" rule in a variety of contexts, as it had for many years. There has never been a doctrine of "social contract" or "social compact" in Pennsylvania in which utilities were relieved from the "used and useful" rule as the electric companies and the *amici* suggest.[15]

The Pennsylvania Public Utility Commission has applied the "used and useful" rule at least since 1916, when in *Thayer v. Beaver Valley Water Company*, P.U.R. 1916E 962, 978-81 (1916) the commission (then known as the Pennsylvania Public Service Commission) disallowed a variety of water transmission lines, reservoirs and other structures from the rate base of a water company because they were not used and useful. The Public Service Commission stated, "The fact that the duplicate pipelines and building are being used does not support the claim that they constitute value for rate making; they may be 'used' but they are not 'useful' because they are unnecessary." *Thayer*, at 979.

A large number of similar decisions have been made by the Pennsylvania Commission since. Recent examples from the period 1971-1981 include:

> *Garber v. Philadelphia Suburban Water Co.*, 45 Pa.P.U.C. 118, 128, 129 (1971) (houses occupied by utility personnel as residences not used and useful); *Pennsylvania Public Utility Commission v. Philadelphia Suburban Water Co.*, 46 Pa.P.U.C. 288, 296 (1972) (unused land parcel); *Pennsylvania Public Utility Commission, et al. v. Consolidated Water Company of Coudersport*, 46 Pa.P.U.C. 620, 626 (1973) (unused reservoir and plant); *Pennsylvania Public Utility Commission et al. v. Duquesne Light Co.*, 48 Pa.P.U.C. 14, 26 (1974) (three unused generating stations); *Pennsylvania Public Utility Commission*,

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[15] An extensive search of authority among the states has failed to turn up even a single example of a state court or regulatory agency which has adopted the electric companies' social contract theory. In the *single* decision found which discusses the claim, it was rejected. *Washington Utilities and Transportation Commission*, Cause No. U-85-50, et al. (Washington Utilities and Transportation Commission, 1986) (slip opinion).

et al. v. Philadelphia Suburban Water Co., 48 Pa.P.U.C. 358, 369 (1974) (unused land parcel); *Pennsylvania Public Utility Commission v. Allegheny County Steam Heating Co.*, 49 Pa.P.U.C. 82, 90 (1975) (construction work in progress); *Pennsylvania Public Utility Commission v. Metropolitan Edison Co.*, 50 Pa.P.U.C. 82, 94-103 (1976) (retired plant, land held for future use, unused common plant facilities); *Pennsylvania Public Utility Commission v. Pennsylvania Electric Co.*, 51 Pa.P.U.C. 649, 654 (1978) (repairs to faulty construction, unused coal lands); *Pennsylvania Public Utility Commission v. Metropolitan Edison Co.*, 53 Pa.P.U.C. 329, 332-34, 29 PUR4th 502 (1979) (damaged nuclear power plant out of service); *Pennsylvania Public Utility Commission v. West Penn Power Co.*, 53 Pa. P.U.C. 410, 419, 32 PUR4th 245, 252-3 (1979) (construction work in progress, plant held for future use); *Pennsylvania Public Utility Commission v. Philadelphia Electric Co.*, 54 Pa.P.U.C. 1, 7, 33 PUR4th 319, (1980) (Commission, while allowing oversized gas line in rate base, declares that it adheres to the used and useful standard regardless of the prudence of construction); *Pennsylvania Public Utility Commission v. Pennsylvania Power and Light Co.*, 54 Pa.P.U.C. 645, 648-53 (1981) (construction work in progress, land held for future use and unused, expensive and risky coal reserves)

The "used and useful" rule has been applied over a long period of time, both in Pennsylvania and in other jurisdictions.[16] These repeated applications of the "used and useful" rule provide ample notice to utility investors that they bear the risk of reduced or no compensation for the investment in idle, incomplete or excess capacity facilities.

Similarly, the Courts of Pennsylvania have recognized the "used and useful" rule is a valid ratemaking principle and have

[16] *See generally*, the large number of commission and court cases applying the "used and useful rule" from 1953-1982 in the P.U.R. Digest, 3d Series under the topics *Valuation*, §§193-215 and *Expenses*, §35.

repeatedly affirmed its use.[17] The rule is contained in the text of several provisions of the Pennsylvania Public Utility Code.[18]

F. The "used and useful" rule protects a rational state interest in risk allocation.

The missing part of the puzzle here is the historical allocation of business risk. If investors in public utility enterprises are aware of the existence of the "used and useful" rule and invest anyway, there can be *no* investment backed expectation that the rule will not be applied. In fact, that is the case. In view of the long history of application of the rule by the Pennsylvania commission and by other state commissions, it would be hard for any investor at all interested in the subject of rate regulation to assert that the rule is now a surprise. In fact, the relationship between the used and useful rule and the assumption of risk by investors has been consistently recognized by

[17] *See Schuylkill Valley Lines, Inc. v. Pennsylvania Public Utility Commission*, 165 Pa. Superior Ct. 393, 398, 68 A.2d 448, 451 (1949), *City of Pittsburgh v. Pennsylvania Public Utility Commission*, 171 Pa. Superior Ct. 187, 200-01, 90 A.2d 607, 614-15, (1952), *Philadelphia v. Pennsylvania Public Utility Commission*, 173 Pa. Superior Ct. 38, 53, 95 A.2d 244, 251 (1953), *Riverton Consolidated Water Co. v. Pennsylvania Public Utility Commission*, 186 Pa. Superior Ct. 1, 11, 140 A.2d 114, 119 (1958), *Bell Telephone Company of Pennsylvania v. Pennsylvania Public Utility Commission*, 47 Pa. Commonwealth Ct. 614, 629-30, 408 A.2d 917, 925 (1979), *UGI Corp. v. Pennsylvania Public Utility Commission*, 49 Pa. Commonwealth Ct. 69, 78, 410 A.2d 923, 928 (1980), *Park Towne v. Pennsylvania Public Utility Commission*, 61 Pa. Commonwealth Ct. 285, 293-94, 433 A.2d 610, 615 (1981), *Philadelphia Electric Co. v. Pennsylvania Public Utility Commission*, 61 Pa. Commonwealth Ct. 325, 329-30, 433 A.2d 620, 623 (1981), *Pennsylvania Electric Co. v. Pennsylvania Public Utility Commission*, 509 Pa. 324, 502 A.2d 130 (1985), *appeal dismissed sub nom. Metropolitan Edison Co. v. Pennsylvania Public Utility Commission*, 476 U.S. 1137 (1986), *Pennsylvania Power & Light Co. v. Pennsylvania Public Utility Commission*, 101 Pa. Commonwealth Ct. 370, 376-77, 516 A.2d 426, 430 (1986).

[18] *See* 66 Pa. C. S. §§1310(a), (d). "Rate Base" is defined at 66 Pa. C. S. §102 as "[t]he whole or any part of the property of a public utility which is used and useful in the public service."

commentators ever since *Hope Natural Gas*. *See* Hale, *Utility Regulation in the Light of the Hope Natural Gas Case*, 44 Harv. L. Rev. 488 (1944), H. Brown, *The Ghosts of the Hope Natural Gas Decision*, 32 Calif. L. Rev. 398 (1944). *See also* Note, *Accounting for Extraordinary Obsolescence*, 65 Harv. L. Rev. 1431, 1442-43 (1952), where a student commentator, discussing *Washington Gas Light Co. v. Baker*, 188 F.2d 11 (1950), *certiorari denied*, 340 U.S. 952 (1951), demonstrated that the long-standing use of the "used and useful" rule makes it almost impossible for a utility to show that its investors have not been compensated for the risk that the rule will be applied.

In a more recent commentary, Drobak, *From Turnpike to Nuclear Power: Constitutional Limits on Utility Rate Regulation*, 65 B.U.L.Rev. 65, 123 (1985) (hereinafter *Drobak*), the allocation of risk imposed by application of the "used and useful" rule was shown to be a matter of policy within the limits of state police power:

> Imposing cancellation costs on shareholders makes them bear the risks of changes in the energy and capital markets and the regulatory risks inherent in the use of such a potentially dangerous and heavily regulated product as nuclear power. As a matter of sound utility regulation, other principles require that customers bear some of the cancellation costs (footnote omitted). As a matter of constitutional law, however, the justifications for imposing the costs on investors support the constitutionality of the kind of rate order [which disallows power plant cancellation costs even if substantial]. The Hope doctrine and the takings cases support no other conclusion.

Drobak, 65 B.U.L.Rev. at 123-24.

Pennsylvania rate orders do in fact consider business risk when fixing rates. Consideration of such risk occurs in the calculation of the fair return which a utility may earn upon its used and useful rate base. The calculation is based upon an analysis of the cost of equity in the capital markets. For

Duquesne Light Company, that assessment is discussed in a portion of Commission's rate order printed at App. 74c-93c. Duquesne's witness Brennan testified that the return to an equity investor includes three factors:

> (1) bare rent or the basic time cost (value) of money; (2) an inflation factor; and, (3) the risk element (equity risk premium) to reflect the degree of risk inherent in the difference between a low risk, near guaranteed obligation, such as a utility long-term debt investment, and a utility common stock investment.

(App. 84c-85c) Pennsylvania Power's witness Hanley offered similar testimony (App. 46e-47e).

The Commission's rate awards include a greater return for equity holders because of the increased risks that such shareholders bear. The record demonstrates that Duquesne Light Company was granted a 16.14% rate of return on equity, a figure substantially higher than the 9.42% cost of debt, in order to recognize and compensate the utility for its business risks (App. 79c and 93c). For Pennsylvania Power Company a similar incremental allowance was granted to recognize the degree of business risk faced by equity investors. The allowed rate of return on equity was 15.72%, again substantially higher than the 10.25% cost of debt (App. 48e). It should not be a novel or controversial proposition that the owners of the business should bear the risks of the business. Indeed, the risk of reduced compensation, or no compensation for non-used and useful facilities, has always been a fundamental and recognized risk of the utility business. Otherwise there would be no justification for granting higher returns to equity investors than the current cost of debt.

When *amicus* EEI characterizes the events leading to the cancellation of the plants involved in this appeal as "unexpected, unforeseeable developments"[19] at page 8 of its

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[19] It is axiomatic that while the existence of business risk is predictable, its individual occurrences are not. Thus, such occurrences are always an unexpected, unforeseen development.

Brief, they belie nearly 100 years of state and federal court precedent which establishes the police power of the state to allocate the risk of failed projects to utility investors. When PEA denies that there is any "state interest that could possibly justify" requiring a utility to bear the risks of construction, it is asking for a radical redefinition of the policy making and police powers of the States.

It is noted that the appellants and supporting *amici* rely heavily upon recent cases of this Court dealing with governmental intrusion or physical appropriation of property. This reliance is misplaced. Since this case involves ratemaking, not the physical control or intrusion upon land or property, the assertion that investors have a reasonable expectation in the recovery through rates of the cost of plant that may later be excluded from rate base because it is not used and useful does not end the constitutional inquiry. It must also be shown that the application of the "used and useful" rule would so fundamentally frustrate a utility from earning a return upon its total investment that the basic "investor interest" of *Hope Natural Gas* - would be imperilled. That would require a showing that such a utility would be unable to earn a return upon its total investment sufficient to attract capital, maintain a reasonable standard of credit, earn a return commensurate with comparable risk enterprises, and maintain service to the public.

In *Keystone Bituminous Coal*, U.S. , 107 S.Ct. 1232, 1247-48 (1987) your Court found that a taking was not established because despite the mining regulations, mining was still commercially practicable. In *Hodel*, 452 U.S. 264, 295-96 the facial attack upon mining regulations was rejected because, even if mining were to be made impractical, the coal lands could be devoted to other uses, such as timber, recreation and so forth. Where, as in this case, there is no actual physical appropriation or burden upon realty or personalty, the electric company's facial attack is far weaker. In many applications of the "used and useful" rule, the plant continues to have economic value and can be sold or devoted to other uses. The "used and

useful" rule simply prevents it from being forcibly charged to rate payers.[20]

Finally, even if complete destruction of the value of the failed investment were demonstrated, Appellants would have to demonstrate that, upon balancing the investor and consumer interest, denial of the recovery of such investment through utility rates would not serve a valid public purpose. *Hope Natural Gas, Permian Basin*. The electric companies have failed to make any of the above showings in their facial attack upon the Pennsylvania Public Utility Code.

G. Act 335 is a valid exercise of the police power.

The very heart of state rate regulation is in the protection of the public interest in obtaining adequate, efficient, safe and reasonable public utility service at just and reasonable rates. The nature of public regulation of privately owned utilities makes it a rational goal to encourage the provision of such beneficial service through rate regulation, rather than through direct governmental intervention in the operations of regulated utilities. The courts of Pennsylvania have in fact repeatedly held that the Pennsylvania Public Utility Commission may not act as a "super board of directors" in judgment of all the expenditures made by a utility. *Bell Telephone Co. of Pennsylvania v. Driscoll*, 343 Pa. 109, 118, 21 A.2d 912, 916 (1941). It is literally impossible for any regulatory commission to supervise utility operations on a day to day basis.

Despite the electric companies' false assertion that the Commission's order in *I.D. 138*, 46 Pa. P.U.C. 23 (1972) gave them the "go ahead" to build additional capacity without fear of the application of the "used and useful" rule, that was not what

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[20] Examples might include excess generating plant capacity, lavish or exorbitant company facilities, land owned by the utility with no definite planned use, obsolete plant with scrap value and so forth. Such items, excluded from rate base, will still have economic value which is not destroyed by a refusal by the State to allow a recovery of the cost of such plant through public utility rates.

that order expressed or intended. The Commission did not have the power to dictate utility generating construction programs. *Bell Telephone*, at 118, 21 A.2d at 916.[21] It is significant that the electric companies have never demonstrated that they actually and reasonably relied upon that order as relieving them from the risks associated with the utility business. In order to claim a constitutional investment backed expectation that the Commonwealth of Pennsylvania would permit the recovery through rates of the costs of failed generating construction, the

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[21] In fact the electric companies attempted to derail the CAPCO investigation below, asserting that the Pennsylvania Public Utility Commission lacked the jurisdiction to even inquire into their generation construction plans. The ALJ below commented on this in his order. App. 6h-7h. The electric companies' May 14, 1980 *Petition to Terminate the Investigation* was denied. The petition stated in part:

> It should be noted again that this Commission lacks jurisdiction over the planning and siting of electric generating stations. As a result a utility may plan and construct a generating station . . . without the need for the express approval of this Commission. The first time that the utility must seek this Commission's approval is in the rate proceeding subsequent to its being placed in service . . . [and] this Commission also has no specific jurisdiction also over the selection of the type of fuel used to generate the electricity . . . It is hornbook law that the Commission is not a superboard of directors managing the affairs of a utility. This Commission was not established for the purpose of telling a utility when to place a generating plant on line, nor is it proper for a quasi-judicial body to work out the ratemaking treatment of a plant . . . outside the context of a rate proceeding. (citing the Administrative Law Judge's decision in Pennsylvania Public Utility Commission v. Philadelphia Electric Co., R-79060865, slip op. at 63-73 (Pa.P.U.C. 1980)

App. 7h.

The CAPCO cancellations were announced on January 23, 1980 (App. 8h). The electric companies' present theory (that *I.D. 138* was a constitutional justification for recovery of the cancellation costs) represents a change in their original position that the Pennsylvania Public Utility Commission actually *lacked jurisdiction* to inquire into their construction program.

electric companies would have had to prove such reasonable reliance to their detriment.

In the competitive marketplace, the economic penalty for excessive or unnecessary construction is levied without appeal. If a competitive firm attempts to include the cost of obsolete, lavish, useless or failed construction in the price of its products, the profits of the firm are directly affected.

The legislature is permitted to conclude that the same economic incentives should be applied to rate regulation of monopoly enterprises. The legislature also is permitted to conclude that it is more efficient, and more effective to prescribe standards for ratemaking which exclude from rate base the cost of plant that is not used and useful in the public service than to depend upon minute, continuous and ubiquitous supervision of utility operations. Both such conclusions are rational and in furtherance of a legitimate state objective. The "used and useful" rule enunciated by the Supreme Court of Pennsylvania is nothing more than a rational application of the police power to a matter wholly within the regulatory powers of the state. As the decision of the Supreme Court of Pennsylvania is adequately grounded in the Constitution of Pennsylvania and in the interpretation of valid Pennsylvania enactments, it should be affirmed. Pennsylvania Constitution, Article 1, Section 10, *National Wood Preservers, Inc. v. Commonwealth of Pennsylvania*, 489 Pa. 221, 414 A.2d 37 (1980), *appeal dismissed*, 449 U.S. 803.

The facial attack upon the Pennsylvania Public Utility Code is invalid and should be dismissed.

II. The Electric Companies' Attack on the Pennsylvania Utility Code as Applied Is Without Merit

A. As applied, Act 335 adequately balances investor and consumer interests.

As interpreted by the Pennsylvania Supreme Court, Act 335 and the Pennsylvania Public Utility Code require that all

cancelled plant costs be excluded from the computation of just and reasonable rates. Neither a return on nor a return of the investment in cancelled plant costs may be charged to consumers (App. 15a). The electric companies allege that, as applied, this precludes the Pennsylvania Public Utility Commission from properly balancing investor and consumer interests and therefore that the statute mandates an unconstitutional taking of its property in violation of the Fifth and Fourteenth Amendments to the United States Constitution.

In narrowly focusing their argument on the denial of cancelled plant costs, the electric companies fail to mention that the Pennsylvania Public Utility Commission rate orders at issue in this appeal granted substantial overall rate increases to each company[22] and that the denial of the investment in cancelled plant costs would reduce the companies' allowed operating revenues by less than one percent. Moreover, in focusing their argument on the treatment of a single and relatively minor element of the many elements that comprise the companies' revenue allowances, the electric companies fail to address properly the standard by which a reviewing court will examine the constitutionality of rate orders.

In determining whether rates are "just and reasonable", as required by the United States Constitution, your Court has held that rates must effectively balance investor and consumer interests with respect to the total impact of the rate order. "If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end." *Hope Natural Gas*, 320 U.S. at 602. Thus, in order to successfully begin a challenge to the constitutionality of Act 335 as applied, the electric companies must demonstrate, at the very least, that the overall effect, the total effect on its allowed revenues, will have a significant adverse impact on investor interests. The

[22] The Commission granted rate increases amounting to $105.9 for Duquesne (App. 126c) and $15.4 million for Penn Power (App. 110e).

electric companies have failed to make that necessary demonstration.

After nearly fifty years of judicial review regarding details of the ratemaking methods and elements used by regulatory commissions in fixing rates, your Court abandoned that approach in the *Hope Natural Gas* case. *Hope Natural Gas* involved an appeal by an interstate natural gas pipeline company of the rates fixed by the Federal Power Commission (FPC). In reducing the pipeline's rates, the FPC had established an interstate rate base using the book cost less depreciation of the pipelines facilities. On appeal, the pipeline contended that the FPC should have found a higher rate base using the pipeline's proffered estimates of reproduction cost and trended original cost of the facilities. The pipeline also complained of the FPC's exclusion from rate base of certain well drilling expenses and other overhead items that had been previously charged to operating expenses in prior years.[23]

This Court relied upon its earlier opinion in *FPC v. Natural Gas Pipeline Company*, 315 U.S. 575 (1942), to hold that the FPC was "not bound to the use of any single formula or combination of formulae in determining rates[.]" and that under the just and reasonable standard for evaluating the constitutionality

[23] It appears that while the pipeline was still claiming the benefit of a reproduction cost rate base, it invited your court to adopt the kind of "prudent investment" rate base now urged by the Appellants and *amici*. Hope Natural Gas Company argued to your Court that:

> Nothing could be plainer than that in Mr. Justice Brandeis' view, original cost is the amount of money originally paid to establish the utility. He said nothing about the amount of money that was charged to capital accounts on the books of the company and nothing about corrections for accounting errors. He said original cost was a *fact* to be ascertained by an examination of the original work orders, vouchers, books and other records of the company.

Brief on Behalf of Hope Natural Gas Company, at 37, *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

of rate orders, "it is the result reached not the method employed which is controlling." 320 U.S. at 602. Your Court went on to hold that the fixing of just and reasonable rates "involves a balancing of the investor and consumer interests." 320 U.S. at 603. The investor interest was described as follows:

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock.

320 U.S. at 603. There was no need for your Court to go further in defining the consumer interest side of the balancing standard because in *Hope Natural Gas* the pipeline's investor interests were fully satisfied.

> The conditions under which more or less might be allowed are not important here. Nor is it important to this case to determine the various permissible ways in which any rate base on which the return is computed might be arrived at. For we are of the view that the end result in this case cannot be condemned under the Act as unjust and unreasonable from the investor or company viewpoint.

320 U.S. at 603.

This Court described in detail the successful financial operations of the pipeline (regular cash dividends, substantial earned surplus, high average earnings, etc.) and concluded that the lower rates established by the FPC were just and reasonable because they nevertheless permitted the pipeline to earn an adequate return after payment of its operating expenses.

> Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they

> might produce only a meager return on the so-called 'fair value' rate base.

320 U.S. at 605.

Consequently, your Court rejected the argument that the FPC erred in failing to consider the pipeline's reproduction cost and trended original cost estimates and the further argument that FPC erred in failing to add certain well-drilling and other costs to the rate base pursuant to a prudent investment theory.

Given this Court's "end result" approach to analyzing the constitutionality of rate orders, the detailed financial examination of rate making methods and elements undertaken since *Smyth v. Ames*, 169 U.S. 466 (1898), came to an end. In its place, *Hope Natural Gas* established new constitutional parameters that emphasize the necessary "balancing of investor and consumer interests" measured with respect to the "total effect of the rate order." Furthermore, *Hope Natural Gas* shifted the constitutional analysis from the valuation of specific assets to the capital invested by stockholders in the enterprise, as suggested by Mr. Justice Brandeis' concurring opinion in *Missouri ex rel. Southwestern Bell Telephone Company v. Public Service Commission*, 262 U.S. 276, 289-312 (1923). *Hope Natural Gas* also established a principle of judicial restraint where the legitimate interests of the complaining party are fully satisfied. Because the pipeline company in *Hope Natural Gas* was able to operate successfully and to attract capital even under the reduced rates ordered by the FPC, judicial inquiry as to whether the FPC rate order struck the appropriate balance between investor and consumer interests became irrelevant. 320 U.S. at 605.

Therefore, in order for a utility to initiate a Constitutional inquiry under the Takings Clause as to whether a ratemaking order reflects an appropriate balance of investor and consumer interests, measured with respect to the total effect of the rate order, the utility must demonstrate that its legitimate investor interests have been significantly damaged.

B. The electric companies have failed to allege or prove harm.

In this case, the electric companies have not even attempted to make that demonstration. Unlike *Jersey Central Power and Light Company v. FERC*, 810 F.2d 1168 (D.C. Cir. 1987), where the utility claimed that the denial of certain cancelled plant costs would preclude access to capital markets and damage the firm's financial integrity, 810 F.2d at 1178,[24] the electric

[24] It should be noted that the four judge majority in *Jersey Central* also held that "[t]he Commission is not precluded from employing "used and useful," or any other specific ratesetting formula. Judge Starr, concurring, reviewed the use of the "used and useful" rule by the F.E.R.C. and concluded that if the F.E.R.C. wished to apply the "used and useful" rule to the "enormous" cancellation costs involved in that case, as an administrative agency whose orders must be reviewed by a court, it would have to supply a reasoned explanation. *Jersey Central*, at 1188-1189. Judge Starr agreed with the dissenters that Jersey Central had mounted an "overly broad attack on the 'used and useful principle'[.]" *Jersey Central* at 1188. The four judge minority stated:

> At the heart of Jersey Central's complaint is its dislike of the used and useful principle . . . In its attempt to have the Commission reconsider the doctrine, Jersey Central argues that the precedent does not, or should not, apply to it . . . It is, of course, widely accepted that the Commission may develop principles in one proceeding and then attach precedential or even controlling weight to them in later proceedings.

Jersey Central at 1197.

The minority went on to conclude:

> The majority's sympathy for Jersey Central appears driven by its agreement that the used and useful doctrine is outdated and should be replaced with a pure prudent investment approach. *See* Maj.Op. at 1175, 1180-81 & n.2. By granting a hearing to Jersey Central at this stage of the long and complex ratemaking process, the majority provides the utility a forum in which to argue its causes. But it also interferes with the Commission's discretion in implementing ratemaking policies and procedures. It thereby threatens the well-held maxim that the Commission is 'not bound to use any single formula or combination of formulae in determining rates.' (quoting *Hope Natural Gas* at 602)

Jersey Central at 1215.

It is hardly surprising that the essential gravamen of *Jersey Central* is avoided in the *Brief for Appellants*, at 28, and in the *Brief of the Pennsylvania Electric Association as Amicus Curiae in Support of Appellants*, at 12.

companies are notably silent on the effect that Act 335 would have on their rates. Indeed, the record in this appeal demonstrates that the denial of cancelled plant costs for these utilities will have no significant effect on their financial well-being.

The cancelled plant costs at issue here constitute only a relatively small portion of the total rate base claimed by each utility. For Duquesne, its $34.7 million investment in cancelled plant costs comprises 1.9% of its $1,779.3 million rate base. *See Pennsylvania Public Utility Commission v. Duquesne Light Co.*, 57 Pa.P.U.C. 1, 69-70 (1983). For Penn Power, its $9.6 million investment in cancelled plant costs comprises 2.4% of its $401.8 million rate base. *See Pennsylvania Public Utility Commission v. Pennsylvania Power Co.*, 58 Pa.P.U.C. 305, 365-66 (1984). In terms of allowed operating revenues, the denial of cancelled plant cost amortization has an even lesser significance. For Duquesne, the Pennsylvania Public Utility Commission approved rates that would yield $802.5 million in annual operating revenues; denial of the cancelled plant amortization would reduce that annual allowance by $3.5 million, or by 0.4%. Similarly, for Penn Power, the Pennsylvania Public Utility Commission approved rates designed to yield $184.2 million in annual operating revenues; denial of the cancelled plant amortization, as required by the Pennsylvania Supreme Court interpretation of Act 335, would reduce that annual revenue allowance by $1.0 million, or by 0.5%.

The electric companies have no basis to claim that the rate adjustment required by the Pennsylvania Supreme Court decision, reducing their operating revenues by less than one per-

cent, will have a significant adverse affect on investor interests. Given the relatively insignificant diminution in allowed operating revenues, the electric companies are unable to claim that the reduced rate level would not "enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed. . . ." 320 U.S. at 605.

C. Regulation does not insure net revenues, it balances investor and consumer interests.

Even where the record demonstrates a significant adverse effect on investor interests, *Hope Natural Gas* teaches that conditions exist where more or less might be constitutionally permissible since "regulation does not insure that the business shall produce net revenues." 320 U.S. at 603. (quoting *Natural Gas Pipeline Co.*, 315 U.S. at 590). The investor interests described in *Hope Natural Gas* represent only half of the equation since the constitutional standard "involves a balancing of the investor and the consumer interests." 320 U.S. at 603. Thus, modern constitutional principles will permit significant damage to investor interests if justified by substantial and legitimate consumer interests. As explained by the concurring opinion in *Natural Gas Pipeline*, which strongly influenced the majority opinion in *Hope Natural Gas*, "the investor interest is not the sole interest for protection. The investor and consumer interests may so collide as to warrant the rate-making body in concluding that a return on historical cost or prudent investment, though fair to investors, would be grossly unfair to the consumers." 315 U.S. at 607-8.

This principle was applied only one year after *Hope Natural Gas*. In *Market Street Railway Company v. Railway Commission*, 324 U.S. 548 (1945), this Court rejected the argument of an ailing transportation utility that, regardless of the depressed value of its properties due to declining demand and increased competition, it was entitled to a return "sufficient to assure confidence in the financial integrity of the enterprise, so

as to maintain its credit rating and to attract capital." In rejecting the utility argument your Court held that the considerations in *Hope Natural Gas*,

> . . . concerned a company which had the advantage of an economic position which promised to yield what was held to be an excessive return on its investment and on its securities. They obviously are inapplicable to a company whose financial integrity already is hopelessly undermined, which could not attract capital on any possible rate, and where investors recognize as lost a part of what they have put in. . . . Without analyzing rate cases in detail, it may be safely generalized that the due process clause never has been held by this court to require a commission to fix rates on the present reproduction value of something no one would presently want to reproduce . . . or on an investment after it has vanished, even if once prudently made, or to maintain the credit of a concern whose securities are already impaired. The due process clause has been applied to prevent governmental destruction of existing values. It has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces.

324 U.S. at 566-67. (Citations omitted.)

Market Street demonstrates that not all utilities are entitled to the strong financial position described in *Hope Natural Gas* and that the consumers are not required to compensate the utility for competitive losses. In *Market Street* it was "grossly unfair to consumers" to require the payment of higher rates that would only exacerbate the financial problems of a dying utility and accelerate its demise. The precedent of *Market Street* is particularly applicable to this appeal as well. Where changing economic conditions have eliminated the need for cancelled power plants it is up to the states to decide whether investors or consumers or both shall bear the associated risks and losses. In the event that the legislature determines that the risk of

doing business shall be borne by utilities and utilities have been afforded a return upon their investment which includes a return for such risk of business,[25] the United States Constitution is not implicated.

In *Permian Basin*, 390 U.S. 747 (1968), your Court determined that the public interest in efficiently establishing the rates for thousands of natural gas producers by the use of average cost data and area pricing outweigh the investor interests of individual higher cost producers. The practice was not unconstitutional since "[r]egulation may, consistently with the Constitution, limit stringently the return recovered on investment, for investors' interest provide only one of the variables in the constitutional calculus of reasonableness." 390 U.S. at 769 (citing *Covington & Lexington Turnpike Road Co. v. Sanford*, 164 U.S. 578, 596 (1896)).

Market Street and *Permian Basin* demonstrate that the constitution will permit investor interests to suffer provided that substantial and legitimate public interest concerns can justify that result. Assuming that the denial of cancelled plant costs would damage the electric companies' financial integrity, the consumers' interest in not paying for generating plants that have never provided any electric service to the public easily outweighs the slight harm to investor interests in this case. The record demonstrates that disallowance of the cancelled plant amortization pursuant to Act 335 would reduce each utility's total annual operating revenues by *less than one percent*. The electric companies have not even attempted to argue that this disallowance would not leave those firms with enough revenues to cover their operating expenses and capital costs. Consumers have a compelling interest in not paying for the costs associated with excessive expenditures, mismanagement, inefficient opera-

[25] Duquesne was granted a 16.14% rate of return on equity (App. 93c), while Pennsylvania Power Company was granted a 15.72% rate of return on equity. These returns are substantially higher than the electric companies' cost of debt in order to recognize and compensate equity investors for business risks.

tion, imprudent construction, excess capacity facilities and idle facilities. Stated another way, consumers should bear only the reasonable costs of providing service to the public. In providing that "the cost of construction or expansion of a facility undertaken by a public utility . . . shall not be made a part of the rate base nor otherwise included in the rates charged by the electric utility until such time as the utility is used and useful in service to the public," Act 335 represents a codification of the consumer interest in this regard. The cancelled plants at issue in this appeal never provided service to the public and the consumer interest in not paying for these abandoned projects easily outweighs the slight harm to investor interest in this case.

D. The focus of constitutional analysis is upon the total effect of the rate order as applied, not its effect upon individual assets.

In *Hope Natural Gas*, your Court shifted the focus of the constitutional analysis from individual assets to the total effect of the rate order on investor interest. While the electric companies readily acknowledge this fundamental shift in constitutional analysis, the remainder of their brief focuses entirely on the treatment of specific assets, the four cancelled plants. While the Pennsylvania Public Utility Commission below allowed the recovery of cancelled plant costs from consumers as a matter of state regulatory policy, the denial of all cancelled plant costs in this case does not constitute a taking without just compensation under the constitutional principles outlined by your Court in *Hope Natural Gas* and *Permian Basin*.

There has been no showing by the electric companies that these cancelled plant costs ever became property for the purpose of rate recovery. Under *Board of Regents v. Roth*, 408 U.S. 564 (1972) and *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 161 (1980) the electric companies must demonstrate that they had something more than a unilateral expectation of recovery of such costs. This they have not

done. Neither the Commission investigation order cited by the electric companies nor the legislative encouragement of the development of nuclear power by "President Eisenhower, each of his successors and the Congress"[26] gave Duquesne Light Company, Pennsylvania Power Company or any other utility *carte blanche* to collect the costs of failed nuclear construction through rates. There was no direction by the Commonwealth of Pennsylvania to the electric companies either to build or to cancel the plants in question. There is no "social contract" or "social compact" which overrides regulation and the public interests protected by the "used and useful" rule. Without such a showing, the electric companies have not made out even a preliminary case for consideration under the Takings Clause. As the Pennsylvania Supreme Court held in a recent case,

> The 'used and useful' concept came into existence long before the *Hope* decision was rendered, and it is not generally regarded as having been overridden by that decision. The concept continues to be of application in this Commonwealth. (citation omitted) Recently, in Barasch v. Public Utility Commission, 507 Pa. 496, 491 A.2d 94, 104 (1985), we noted the legislature's longstanding policy that current ratepayers should shoulder only the costs of providing current utility service, with such costs to be determined by reference to such property as is 'used and useful' in service to the public. . . . The 'used and useful' principle is soundly based, for it serves to protect consumers from exploitation, and it comports with the view that, in fairness, consumers should not be required to buoy up failing utility companies by being required to, in effect, provide public subsidies for utility properties that are not useful in the public service.

Pennsylvania Electric Co. v. Pennsylvania Public Utility Commission, 509 Pa. 324, 333-34, 502 A.2d 130, 135 (1985), *appeal*

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[26] *Brief of the Edison Electric Institute*, at 8.

dismissed sub nom. Metropolitan Edison Co. v. Pennsylvania Public Utility Commission, 476 U.S. 1137 (1986).

There has also been no showing based on the total effect of the rate order that investor interests have been adversely affected to any significant degree. Moreover, even assuming that the harm to investor interests is significant enough to warrant a *Hope Natural Gas* inquiry into the appropriate balance of investor and consumer interests, the relatively slight harm to investor interests in this case is easily outweighed by the substantial and legitimate consumer interest in not paying for facilities that provide no service to the public.

Under these circumstances, your Court should find that Act 335, as applied, reflects a constitutionally permissible balancing of investor and consumer interests and dismiss the electric companies' facial attack against the Pennsylvania Public Utility Code.

III. The Invitation of the Amici Curiae To Adopt a Risk Free "Prudent Investment" Rule as a Constitutional Standard Should Be Rejected

One may search earnestly for a clear admission by the electric companies and the *amici* supporting the electric companies that *Hope Natural Gas* rejected the "prudent investment" rule as a constitutional test of utility ratemaking.

Yet your Court has so held. In *Wisconsin v. Federal Power Commission*, 373 U.S. 294, 309 (1963), your Court held:

> [T]o declare that a particular method of rate regulation is so sanctified as to make it highly unlikely that any other method could be sustained would be wholly out of keeping with this Court's consistent and clearly articulated approach to the question of the Commission's power to regulate rates. It has repeatedly been stated that no single method need be followed by the Commission in considering the justness and reasonableness of rates, [citations omitted] . . . Indeed the prudent investment, original

> cost, rate base method which we are now told is lawful, established, and effective is the very one the Court was asked to declare impermissible in the Hope case, less than 20 years ago.

Wisconsin at 309.

Nevertheless, *amici*, and somewhat obliquely the electric companies, urge that this Court adopt the "prudent investment" model as the benchmark for the constitutionality of utility ratemaking.[27] The Pennsylvania Public Utility Commission urges this Court to reject the invitation.

The "prudent investment" rule, as advanced by Mr. Justice Brandeis in numerous dissents, was an attempt to persuade your Court in the pre-*Hope Natural Gas* era that reliance upon reproduction cost as a constitutional standard was an exercise in delusive exactitude.[28] It is significant that although the major

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[27] The electric companies claim that *Hope Natural Gas* involved a utility challenge to the basing of annual depreciation charges on original cost. From that, the electric companies glean the concept that *Hope Natural Gas* created a constitutional distinction between return *on* an investment and return *of* an investment. Having somewhat mischaracterized that case, the electric companies go on in footnote 25 of *Brief for Appellants*, to bootstrap that mischaracterization into a flat assertion that a denial of rate recovery of prudently invested capital causes investors to "forfeit" the invested funds and creates a *per se* taking. As was discussed in Part I of this Brief, that assertion is untrue. Many items of plant that might be excluded from a utility's rate base for ratemaking purposes still have economic value even if that value must be recovered through a means other than utility rates. It appears that the intent of footnote 25 is to bring utility ratemaking within the scope of this Court's recent decisions on the regulation of real estate, zoning and land use. This attempt is unwarranted, as your Court applies a far higher degree of scrutiny where real estate is involved.

[28] Mr. Justice Brandeis's initial discussion of the "prudent investment" rule occurred in *Galveston Electric Company v. City of Galveston*, 258 U.S. 388 (1922) where he authored the majority opinion. In *Galveston*, the "prudent investment" rate base was defined as "the estimated undepreciated cost of reproduction of railway property of the company on the historical basis, exclusive of franchise value, going concern value, bond discount and brokerage fee," but with land and right of way which cost about $15,000 estimated at their present value of $58,836. *Galveston*, at 258 U.S. 391, n.1.

parties before this Court in the *Hope Natural Gas* argued whether the adoption of the "prudent investment" rule was a preferable standard to that of *Smyth v. Ames*, your Court de-

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By the time he dissented in *State of Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276, 289-312 (1923) "prudent investment" had changed to become the original cost of the property not excluding "investments which, under ordinary circumstances, would be deemed reasonable. The term is applied for the purpose of excluding what might be found to be dishonest or obviously wasteful or imprudent expenditures." *Southwestern Bell Telephone*, at 289 n.1. The last major dissent on the basis of "prudent investment" was in *United Railways and Electric Co. of Baltimore v. West*, 280 U.S. 234 (1930), in which Mr. Justice Brandeis declared that "if, instead of applying the rule of Smyth v. Ames, the rate base of a utility were fixed at the amount prudently invested, the inevitable errors incident to estimating service life and net expense in plant consumption could never result in injustice either to the utility or to the community." *United Railways*, at 280 U.S. 279. It is significant that Mr. Justice Brandeis joined in the majority opinion in *Los Angeles Gas & Electric Corp. v. Railroad Commission of California*, 289 U.S. 287 (1933), in which Mr. Justice Hughes, supporting a $3 million deduction from a fair value rate base to eliminate an obsolete plant, wrote:

> "The actual cost of the property—the investment the owners have made—is a relevant fact. (citing *Smyth v. Ames*). But, while cost must be considered, the Court has held that it is not an exclusive or final test . . . Even when cost is revised so as to reflect what may be deemed to have been invested prudently and in good faith, the investment may embrace property no longer used and useful for the public."

Los Angeles Gas, at 289 U.S. 306.

Mr. Justice Brandeis retired from the Court in February 1938, and his "prudent investment" rule was never adopted as a Constitutional standard.

clined to adopt a new rule of substantive due process where the old one had failed.

Amicus curiae PEA dangles the enticing prospect that adoption of the "prudent investment" rule will reduce litigation.[29] This cannot be so, for experience teaches that adoption of such standards results in an explosion of litigation.[30] Instead of courts focusing upon what the end result of a specific rate order is upon a specific utility company's financial condition, courts would become bogged down in defining in thousands of regulatory cases of what constitutes "prudence", and what level of prudence is required under the U.S. Constitution; federal courts would return to the unhappy days of reviewing state regulatory decisions on the basis of rules rather than reality. Further, it would involve the federal courts in reweighing the legislation of the states for encroachment on the new penumbra of the "prudent investment" standard.

Fundamentally, it would also require your Court to overrule *Hope Natural Gas* and *Permian Basin* and the constitutional recognition given to consumer interests. Under the risk-free "prudent investment" theory advocated by *amici* the utility investor would be guaranteed a profit on each investment regardless of changed market conditions, feckless utility management

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[29] "[A]micus submits that the appropriate approach," both to secure constitutional values and to protect this Court's docket from the burden of reviewing a plethora of rate decisions, is to adopt the prudent investment test of Justice Brandeis as the constitutional benchmark" *Brief of Pennsylvania Electric Association*, at 23.

[30] For a review of the cases engendered by the *Lochner* era and the adoption of the *Smyth v. Ames* standard of valuation, *see generally*, Siegel, *Understanding the Lochner Era*, 70 Va. L. Rev. 187 (1984). Mr. Justice Brandeis dolefully observed in *Southwestern Bell Telephone* at 262 U.S. 311 (1922) that: "The rule by which the utilities are seeking to measure the return is, in essence, reproduction cost of the utility or prudent investment, whichever is the higher." It is ironic that the electric companies and their Pennsylvania and national associations are here contending for a standard that was anathema to the utilities during the *Smyth v. Ames* era.

or even complete destruction of the plant. In short, investors would be insulated from business risks. *Hope Natural Gas* and *Permian Basin* recognized that the utility business is not risk free and that consumers have legitimate interests which must be fulfilled through the exercise of state police power. Where appropriate, those interests must be fulfilled even at the expense of investor interests.

It would be ill-advised to overturn well established precedent upon the facts of this case. Neither the appellants, nor the *amici curiae* present even a colorable picture of national need for such a break in constitutional doctrine, and precedent of such longstanding should not be abandoned for light and transient causes.

CONCLUSION

This Court should affirm the judgment below, or in the alternative, dismiss this appeal for want of a substantial federal question.

Respectfully submitted,

DANIEL P. DELANEY
Chief Counsel
BOHDAN R. PANKIW*
Deputy Chief Counsel
JOHN A. LEVIN
Assistant Counsel
Attorneys for Appellee Pennsylvania Public Utility Commission
Commonwealth of Pennsylvania
Pennsylvania Public Utility Commission
P.O. Box 3265
Harrisburg, PA 17120
(717) 787-5000

June 30, 1988

**Counsel of Record*

(9)

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In The Supreme Court of the United States

October Term, 1987

Duquesne Light Company
and
Pennsylvania Power Company
Appellants,

v.

David M. Barasch,
Consumer Advocate, et al.
Appellees.

On Appeal from the Supreme Court of Pennsylvania

Brief for Appellee, David M. Barasch, Consumer Advocate

David M. Barasch
Consumer Advocate
Irwin A. Popowsky*
Daniel Clearfield
Debra M. Kriete
Kent D. Murphy
Assistant
Consumer Advocates

Commonwealth of Pennsylvania
Office of Attorney General
Office of Consumer Advocate
1425 Strawberry Square
Harrisburg, Pennsylvania
17120
(717) 783-5048

*Counsel of Record

June 30, 1988

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QUESTIONS PRESENTED

1. Where a public utility appeals a rate decision with respect to a single item in the rate calculation, but fails to demonstrate, or even allege, that the decision will have a significant adverse impact upon the utility's overall rate level or resulting financial condition, can the utility claim that the decision is confiscatory in violation of the Fifth and Fourteenth Amendments?

2. Where this Court's holdings have made it clear that it is the overall result reached, not the method employed, which determines whether a public utility rate order can be challenged as confiscatory, can a utility attack a single provision of a state public utility code on the ground that the ratemaking method mandated by that provision is unconstitutional?

3. Where a state statute codifies longstanding state ratemaking principles which prohibit utilities from charging their ratepayers for the costs of useless investments, is such a law unconstitutional on its face or as applied to a utility's investment in a failed construction project which never has and never will provide service to anyone?

4. Can the General Assembly of Pennsylvania require the Pennsylvania Public Utility Commission to exclude the costs of useless investments from utility rates as a matter of law, where that law is part of a public utility code which requires that the rates of all public utilities must be just and reasonable?

5. Where a provision in a state ratemaking law requires a public utility commission to exclude the costs of certain useless investment in setting just and reasonable rates, is such a provision so irrational or unrelated to any valid state policy that it violates the Due Process Clause of the Constitution?

6. Does the constitutional prohibition against confiscation require the ratepayers of a regulated utility to bear the costs of a failed construction project which is voluntarily cancelled by the utility before the project is completed?

7. Should this Court overturn 44 years of established case law and create a single constitutional rate method under which utilities would be guaranteed a return on all "prudent" investment, regardless of whether that investment is needed, economical, or useful in the provision of service to ratepayers?

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In The Supreme Court of the United States

October Term, 1987

No. 87-1160

Duquesne Light Company
and
Pennsylvania Power Company
Appellants,
v.
David M. Barasch,
Consumer Advocate, et al.
Appellees.

On Appeal from the Supreme Court of Pennsylvania

Brief for Appellee, David M. Barasch, Consumer Advocate

Appellee, David M. Barasch, Consumer Advocate (hereinafter, Office of Consumer Advocate or OCA)[1] files this Brief in opposition to the Brief of Appellants, Duquesne Light Company and Pennsylvania Power Company. The OCA respectfully urges this Honorable Court to affirm the Order of the Pennsylvania Supreme Court dated October 15, 1987, which is the subject of this appeal.

[1]The OCA is an agency of the Commonwealth of Pennsylvania authorized to represent the interests of Pennsylvania utility consumers before the Pennsylvania Public Utility Commission and other state and federal agencies and courts which regulate the activities of Pennsylvania's public utilities. 71 Pa. Stat. Ann. §309-1 *et seq.* (Purdon Supp. 1987). The OCA has represented the interests of the ratepayers of Duquesne Light Company and Pennsylvania Power Company throughout the proceedings which have given rise to the present appeal. Appellee, David M. Barasch, has served as the Consumer Advocate of Pennsylvania since 1984.

STATEMENT OF THE CASE

This is an appeal by two electric utilities from a Pennsylvania Supreme Court Order which found that the Pennsylvania Public Utility Commission (hereinafter, PUC or Commission) had erred as a matter of law by requiring ratepayers to bear the costs associated with four power plants which were voluntarily abandoned prior to completion and which therefore never provided service to those ratepayers.

In two general rate increase proceedings before the PUC, the utilities involved, Duquesne Light Company (hereinafter Duquesne) and Pennsylvania Power Company (hereinafter Penn Power), requested and received the right to recover from ratepayers, over a ten-year period, all money invested by the utilities in the abandoned projects. These rate allowances were appealed by the OCA, but were initially upheld by a 4-3 vote of the Commonwealth Court of Pennsylvania.

The Commonwealth Court Order was reversed by the Pennsylvania Supreme Court, which unanimously ruled in an Opinion by Chief Justice Nix that the PUC rate orders had violated the Pennsylvania Public Utility Code. Specifically, the Supreme Court agreed with the OCA's position that the allowance of rate recovery of the cost of a cancelled power plant violated Section 1315 of the Public Utility Code, 66 Pa. Cons. Stat. §1315 (1987). That provision states, with certain exceptions not pertinent here, that:

> the cost of construction or expansion of a facility undertaken by a public utility producing, generating, transmitting, distributing or furnishing electricity shall not be made a part of the rate base nor otherwise included in the rates charged by the electric utility until such time as the facility is used and useful in service to the public.

Section 1315 further states that:

> Except as stated in this section, no electric utility property shall be deemed used and useful until it is presently providing actual utility service to the customers.

Because there was no dispute that the abandoned plants at issue never have and never will provide actual service to customers, the Supreme Court agreed with the OCA's position that, as a matter of state law, the costs of those plants could not be charged to ratepayers. The Court also noted that this interpretation of Section 1315 was consistent with "the fundamental principles of this state's public-utility jurisprudence", *i.e.*, that "no utility of any type is permitted, without express and valid legislative authorization, to charge ratepayers for property which is not used and useful in the production of current utility service." 532 A.2d 325, 338 (App. 28a-29a).[2] Finally, the Court rejected the utilities' claims that the disallowance of these costs from rates was violative of the Pennsylvania Constitution or the United States Constitution. 532 A.2d 325, 335-39 (App. 21a-31a).

The Pennsylvania Supreme Court did not order any specific changes in the utilities' rates, but rather remanded the matter to the Commission for proceedings consistent with its Opinion. 532 A.2d 325, 339 (App. 31a). Duquesne and Penn Power then took the present appeal to this Court.

Before addressing the Companies' arguments, certain additional points should be noted.

First, as stated by Duquesne and Penn Power in their Brief at 4, the four plants at issue here were cancelled in January, 1980, prior to the issuance of a construction permit by the Nuclear Regulatory Commission. Thus, only "pre-construction" expenditures for such items as engineering and siting analyses are at issue here. *Id.*

For Duquesne, the total pre-construction costs claimed for these

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[2]By order dated April 18, 1988, this Court granted Appellants' Motion to Dispense with Printing of the Joint Appendix. All references to "App." are to the Appellants' Appendix to Jurisdictional Statement.

projects amounted to $34,697,389. (App. 37c). The annual expense allowance permitted by the Commission for the ten-year amortization of this amount was $3,469,739. *Id.* This allowance was a relatively small component of an overall rate increase of $105,850,000, which brought Duquesne's total annual revenue allowance from its Pennsylvania jurisdictional ratepayers to $802,463,063. (App. 126c).

Penn Power's share of the costs amounted to $9,569,665, with the annual amortization allowance equal to $956,967. (App. 81e-82e). This allowance was part of a $15,364,000 rate increase, which raised Penn Power's annual allowed revenues to $184,186,000. (App. 3e-4e).

Next, it should be noted that the majority of the ownership in these four abandoned units was held by three Ohio utilities. As in Pennsylvania, the Ohio Public Utilities Commission initially permitted the recovery of the costs of these units from ratepayers, but that allowance was overturned as violative of state law by the Ohio Supreme Court. *Office of Consumers' Counsel v. Public Utilities Commission*, 67 Ohio St. 2d 153, 423 N.E.2d 820 (1981). The appeal of Cleveland Electric Illuminating Company (CEI) from that Ohio Supreme Court decision — as well as CEI's subsequent appeals from two related orders regarding this same issue — were summarily dismissed by this Court at 455 U.S. 914 (1982), 459 U.S. 1094 (1983), and 464 U.S. 802 (1983).

Finally, the OCA would note that the Appellants in this case were not *ordered* by the PUC or any other regulatory authority to commence construction of the generating plants at issue here. Nor were Appellants *ordered* by any regulatory authority to cancel the units prior to completion. The decisions to commence and to cancel construction of these units were both voluntarily made by the Appellants.

Because of their monopoly status, the Appellants, and all similarly situated Pennsylvania utilities have a statutory obligation

to provide safe and adequate service to all retail electricity customers within their respective service territories. *See* 66 Pa. Cons. Stat. §1501 (1987). However, the manner in which the Appellants meet this obligation to serve is generally a matter of broad management discretion.

During the period in question, Pennsylvania law did *not* require the advance approval of construction decisions. Nor did the Appellants ever seek such approval with respect to the plants involved in this case. Neither did the Appellants seek or obtain advance approval of their decision to cancel the four units. The PUC orders at issue here (Appendices C, D, E, and I) all involved reviews of the Appellants' prior decisions to commence and then to cancel the plants, and the ratemaking treatment which should be accorded to the costs incurred during the period between those decisions.

The Appellants suggest at page 3 of their Brief that they, along with other Pennsylvania utilities, were "instructed" to add capacity in a PUC Order issued in 1972. *Investigation of the Need for Additional Electric Generating and Transmission Facilities*, 46 Pa. P.U.C. 23 (1972). This suggestion is incorrect. In the Order referenced by the Appellants, the PUC did express serious concern over "whether or not an electric energy shortage will develop" in Pennsylvania, but the Commission also questioned whether "the industry's construction program calls for excessive capital investment at the expense of existing rate paying customers." 46 Pa. PUC at 26. The Order did not require the Appellants to build any additional generating capacity, nor did it make any reference to the specific units at issue here. Rather, the Order directed the Appellants and their fellow Pennsylvania electric utilities to file annual reports with the PUC detailing their existing generating plants and setting forth their specific plans to meet customer demands over the succeeding ten years. *Id.* at 26-27.

SUMMARY OF ARGUMENT

In order for the Appellants to prevail in this case, this Court would have to overrule the fundamental principles that have guided the constitutional review of utility rate decisions since *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). The Court in *Hope* ruled that, in reviewing a utility rate order, "it is the result reached not the method employed which is controlling" and that "[i]f the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end." 320 U.S. at 602.

Under *Hope* , a utility cannot even *claim* confiscation in the ratemaking context unless the *overall* rates allowed fail to satisfy the investor interests identified in that decision. A utility has no constitutional right to recover the costs of specific investments. Nor does a utility have a constitutional right to demand the application of any particular ratemaking methodology.

In the present case, the Appellants have not even alleged, let alone demonstrated, that the relatively minor rate disallowances involved in this appeal will have *any* substantial negative impact upon the utilities' overall rates or resulting financial conditions. Instead, the Appellants have challenged the constitutionality of the ratemaking method employed — an issue which this Court repeatedly has stated it will not consider in a utility rate appeal. As such, the Appellants have failed to meet the threshold requirements under which this Court will consider a confiscation claim in the context of a utility rate case. The appeal therefore should be rejected.

To the extent the Court reaches the substantive arguments raised by the Appellants, the OCA submits that those arguments are wholly without merit.

The "used and useful" principle which is challenged by the Appellants remains constitutionally valid after *Hope*. Indeed, *Hope* makes it clear that no particular rate methodology is either constitutionally forbidden or constitutionally required. The principle that ratepayers should not be required to bear the costs of investments

that do not serve them has been a fundamental theme of most state and federal ratemaking methodologies both before and after the Court's decision in *Hope*. While not constitutionally *required*, the used and useful principle is eminently sensible and is clearly constitutionally *permissible* in light of this Court's holding in *Hope*.

The Pennsylvania General Assembly is not barred from establishing the used and useful principle as a matter of statutory law, particularly where that principle is part of the overriding requirement of Pennsylvania law that the rates of all public utilities must be just and reasonable. State legislatures may prescribe specific ratemaking rules to be followed by their designated administrative arms, the state public utility commissions. The specific statute at issue here codified longstanding principles of state public utility law which protect ratepayers from bearing the costs of useless utility investments. Certainly, the legislation passes the requirements for state economic regulation under the Due Process Clause of the Fourteenth Amendment to the United States Constitution.

Neither the challenged legislation, nor the order in this case is confiscatory under the analysis set forth in this Court's recent "takings" jurisprudence. The Appellants voluntarily abandoned work on four power plants and *then* sought "compensation" through the ratesetting process for an investment which was rendered worthless entirely by their own action. The nature of the government regulation here was clearly non-intrusive and the economic impact was minimal. To the extent that investors expected that they would have a right to recover these costs from ratepayers, those expectations were based on misconceptions concerning the applicable Pennsylvania and constitutional law.

This Court should not adopt the "prudent investment" standard — or any other single ratemaking methodology — as the sole constitutionally permissible rate method. The Appellants and their Amici have misinterpreted the prudent investment standard and have recommended an approach which would render unconstitutional the ratemaking frameworks of most state and federal regulatory authorities.

ARGUMENT

I. THE APPELLANTS HAVE FAILED TO MEET THE THRESHOLD REQUIREMENTS FOR CHALLENGING THE CONSTITUTIONALITY OF A UTILITY RATE ORDER.

A. Introduction

While the Appellants purport to base their argument in this case on this Court's landmark decision in *FPC v. Hope Natural Gas Co.*, 320 U.S 591 (1944), it is clear that the appeal can be sustained only if this Court disregards or overrules the fundamental teachings of that case.

Hope marked the end of an era of judicial intervention in utility ratemaking decisions in which the courts, including the lower court in the *Hope* case, had ruled that, as a matter of constitutional right, the "fair value" of the property on which a utility's rates were set had to include some measure of present value or reproduction cost, rather than be based upon the original or historical cost of the property.

The Court in *Hope* thus adopted the view of the concurring opinion of Justice Douglas (the author of the *Hope* opinion), Justice Black and Justice Murphy in *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 607 (1942), that:

> Irrespective of what the return may be on "fair value," if the rate permits the company to operate successfully and to attract capital all questions as to "just and reasonable" are at an end *so far as the investor interest is concerned.*

(emphasis added).

The Court in *Hope* ruled that for purposes of its review, "it is the result reached not the method employed which is controlling"

and that "[i]f the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end." 320 U.S. at 602.

These principles have been consistently observed by this Court in its ratemaking decisions subsequent to *Hope*, yet they are totally ignored or misconstrued by the Appellants here. Appellants have brought an appeal to this Court which challenges, on constitutional grounds, the ratemaking methodology employed in determining only one component of their respective overall rates. Moreover, Appellants raise this issue without even alleging, let alone demonstrating, that the Order below will have any substantial negative impact on the Appellants' overall rates or financial conditions. As such, the Appellants have failed to meet the threshold requirements established in *Hope* under which this Court will consider a confiscation claim in the context of a utility rate case.

B. The Appellants Have Failed To Allege That The Pennsylvania Supreme Court Order In This Case Will Have A Substantial Negative Impact On Their Overall Rates Or Financial Conditions. They Therefore Have No Constitutional Basis On Which To Assert That The Order Is Confiscatory.

In their statement of the first question presented, the Appellants ask this Court to determine whether the Pennsylvania Supreme Court's interpretation of the state law at issue in this case effects an unconstitutional taking "by precluding the state ratemaking agency from considering constitutionally pertinent factors *in determining whether to permit recovery of prudently incurred investment in cancelled electric generating units.*" (emphasis added).

The fundamental flaw in the premise to this question — and the flaw which pervades the Appellants' entire Brief — is the misconception that utility investors have a constitutionally protected interest in the recovery from ratepayers of the costs of *specific* items of investment, rather than in the *overall* justness and reasonableness of the rate levels established for the utility.

Nowhere in their Brief do the Appellants address the impact of the Pennsylvania Supreme Court Order on the companies' overall rate levels or upon their overall financial standing. Yet, it is beyond dispute under this Court's *Hope* decision that a showing of financial harm is the threshold requirement that a utility must meet in order even to present a "takings" claim in the ratemaking context.

The *Hope* decision made it clear that utilities may not challenge a rate order as unconstitutional on the grounds that individual components of the order were deficient. Rather, the Court said, it will *first* look to the *overall impact* of those decisions on the utility. As stated by the Court:

> If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end.

320 U.S. at 602.

This fundamental holding of the *Hope* decision is illustrated most clearly by the Court's treatment of the specific issues raised before it in that case. After finding that the "end result" of the rate order in that case could not be condemned as unjust and unreasonable "from the investor or company viewpoint", 320 U.S. at 603, the Court refused even to consider the utility's claim that the rate base established by the FPC was understated by $17 million. As stated by the Court:

> In view of this disposition of the controversy we *need not stop to inquire* whether the failure of the Commission to add the $17,000,000 of well-drilling and other costs to the rate base was consistent with the prudent investment theory as developed and applied in particular cases.

Id. at 605-06 (emphasis added). It should be noted in this regard that the total rate base *allowed* in the *Hope* case was just $33.7 million. *Id.* at 596. Yet, because the company failed to show that the overall end result of the rate order was unjust and unreasonable to the investors, the Court found it unnecessary even to address the merits of its additional $17 million rate base claim.

The constitutionally pertinent standards set forth by this Court in Hope and the predecessor *Natural Gas Pipeline* decision were summarized by Justice White in his Opinion for the Court in *FPC v. Texaco Inc.*, 417 U.S. 380, 391-92 (1974), as follows:

> *All that is protected against*, in a constitutional sense, is that the rates fixed by the Commission be higher than a confiscatory level. *FPC v. Natural Gas Pipeline Co.*, 315 U.S., at 585. In the context of the Act's rate regulation, whether any rate is confiscatory, or for that matter "just and reasonable," can only be judged by "the result reached, not the method employed."

(*quoting Hope*, 320 U.S. at 602 (emphasis added)). Justice White reiterated this statement in his Opinion for the Court in *FERC v. Pennzoil Producing Co.*, 439 U.S. 508, 519 (1979). Justice White also reasserted in that case the position articulated by the Court in *Natural Gas Pipeline* and the *Permian Basin Area Rate Cases*, 390 U.S. 747, 770 (1968) that a rate which fell within a "broad zone of reasonableness" permitted by the Natural Gas Act "cannot properly be attacked as confiscatory." *See also, FPC v. Conway Corp.*, 426 U.S. 271, 278 (1976) ("[T]here is no single cost-recovering rate, but a zone of reasonableness."); *Montana-Dakota Utilities Co. v. Northwestern Public Service Co.*, 341 U.S. 246, 251 (1951) ("Statutory reasonableness is an abstract quality represented by an area rather than a pinpoint. It allows a substantial spread between what is unreasonable because too low and what is unreasonable because too high.")

In the present case, the Appellants have not alleged — nor could they allege — that the disallowance of their claims for cancelled plant costs would turn the *overall* substantial rate increases granted in these cases from a constitutional to an unconstitutional "end result." It would be an exceedingly small "zone of reasonableness" if this Court were to hold, as a matter of constitutional law, that the $105.8 million annual rate increase granted by the Commission

in the Duquesne rate case would be transformed into an unconstitutional taking if that increase were reduced to $102.4 million as a result of the disallowance of the Company's abandoned plant claim. Similarly, Penn Power could not reasonably allege that the disallowance of less than $1 million from its $15.4 million rate increase in this case would render the overall end result unconstitutional.

In the rate case here on appeal, Duquesne Light Company was authorized to earn a 16.14 percent common equity return and 11.64 percent overall return on a rate base of nearly $1.8 *billion*. (App. 19c, 93c). The total allowed annual revenues to the Company resulting from the $105.8 million rate increase exceeded $800 million. (App. 126c). Clearly, the $3.5 million annual amortization for cancelled plant costs which would be disallowed under the Pennsylvania Supreme Court's Order would have a relatively minor effect on the "end result" of the Commission's Order.

Similarly, in its rate case, Penn Power was authorized to charge a 15.72 percent return on common equity and a 12.02 percent overall return on a rate base of approximately $400 million. (App. 5e, 48e). The Company's $15.4 million rate increase in this case brought its total annual revenues to $184.2 million. (App. 3e, 4e). Penn Power's annual amortization claim for the cancelled plants at issue here amounted to $956,967. (App. 81e-82e).

The OCA has *not* contended, as asserted by Appellants at page 18, note 17, of their Brief, that *Hope* eliminates constitutional review of state rate orders "unless the impact of such an order is to bring the regulated utility to the brink of bankruptcy." The OCA does submit, however, that *Hope* establishes a threshold requirement for claiming confiscation in the utility ratesetting context which the Appellants have not met, and have not even attempted to meet, in this case.

Clearly, utilities, like all other individuals and corporations, are protected from confiscatory government acts. *See, e.g, San Diego Gas & Electric Co. v. City of San Diego,* 450 U.S. 621 (1981). But in the ratemaking context, "[a]ll that is protected against, in a

constitutional sense," is that the overall rates allowed a utility not be set at a confiscatorily low level. *FPC v. Texaco, supra,* 417 U.S. at 391-92. It is entirely appropriate for this Court to limit constitutional review of rate orders to cases in which utilities can demonstrate that the overall result creates substantial harm to investor interests. Otherwise, this Court will once again find itself in the pre-*Hope* position of evaluating ratemaking methods as applied to individual items of utility property, in order to determine whether even minimal reductions in massive proposed rate increases are somehow confiscatory.

The investor interests described in *Hope* clearly pertain to the *overall* level of rates, not to the investment in any particular asset. While the OCA will argue below that the investor interests set forth in *Hope* need not be satisfied in every case, it is clear that these interests have not even been brought into issue by the relatively minor rate adjustments that are likely to result from the Pennsylvania Supreme Court decision in this case.

For this reason, the Appellants' reliance on the decision of the D.C. Circuit Court of Appeals in *Jersey Central Power & Light Co. v. FERC,* 810 F.2d 1168 (D.C. Cir. 1987) (en banc) is also misplaced. In that case, the utility appealed FERC's summary rejection of its request for a hearing on whether its claim for a partial return on abandoned power plant costs (or, alternatively, for a higher rate of return on its other assets) was appropriate under the *Hope* end result test. FERC denied the company a hearing, even though the company alleged that it was in financial distress and that the rate increase requested was "the minimum necessary to restore the financial integrity of the Company." 810 F.2d at 1178. Writing for the majority of a sharply divided court, Judge Bork stated that Jersey Central was entitled to a hearing on its *Hope*-related contentions at that stage of the proceeding. Judge Bork, however, carefully limited the scope of the Court's holding as follows:

> Under *Hope*, as we have stated repeatedly, the *only* circumstance under which there is a *possibility* of a taking of investors' property by virtue of rate regulation is when a utility is

> in the sort of financial difficulty described in Justice Douglas' opinion. If a utility is in that state, the Commission must inquire whether a reasonable return—on investment, not on facilities—has been afforded to investors, taking into account whether any higher return would amount to exploitation of consumers. Under those circumstances, it may be permissible or even proper to grant the utility a greater return on its prudent investments than it otherwise would have received. *But absent the sort of deep financial hardship described in Hope, there is no taking, and hence no obligation to compensate, just because a prudent investment has failed and produced no return.*

Id. at 1181 n.3 (emphasis added).

While the OCA will argue below that the used and useful principle may be applied even where the application of that principle results in financial distress to the utility, the point here is that the *Jersey Central* decision does not support, and indeed contradicts, the position taken by the Appellants in this case.

In the present case, the Appellants have not even alleged, let alone demonstrated, that they have met the requirements for raising a confiscation claim under *Hope*. Their constitutional appeal therefore can and should be rejected by this Court without any need to further address the merits of their specific arguments.

C. The Appellants' "Facial" Attack On The Used And Useful Principle Is Also Misplaced. It Is The Result Reached, Not The Method Employed, Which Is Controlling For The Purposes Of Determining Whether A Rate Order Can Be Challenged As Confiscatory.

In addition to failing to address the financial impact of the Pennsylvania Supreme Court Order on their overall operations, the Appellants have violated another cardinal principle established in *Hope* by focusing their challenge on the "used and useful" ratemaking methodology utilized in this case.

Hope did not mandate, nor did it prohibit, any particular ratemaking methodology. On the contrary, Justice Douglas noted in *Hope* that it is the "total effect of the rate order" which is controlling and that "[t]he fact that the method employed to reach that result may contain infirmities is not then important." 320 U.S. at 602.

Hope recognized that utility ratemaking is properly a legislative function within the police powers of the state. The Court thus firmly rejected the eminent domain theory upon which "fair value" ratemaking had been based. As stated by the Court:

> Rate-making is indeed but one species of price-fixing. *Munn v. Illinois*, 94 U.S. 113, 134. The fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid.

320 U.S. at 601. *See* Hale, *Utility Regulation In The Light Of The Hope Natural Gas Case*, 44 COLUM. L. REV. 488, 488-96 (1944); Drobak, *From Turnpike To Nuclear Power: The Constitutional Limits On Utility Rate Regulation*, 65 B.U.L. REV. 65, 82-88 (1985).

The Appellants in this case recognize, as they must, that *Hope* represented "a major turning point in this Court's takings jurisprudence." Appellants' Brief at 14. Yet, the Appellants inexplicably go on to suggest that *Hope* merely "re-focus[sed] the inquiry from the 'fair value' of particular assets to a return *of* and *on* the shareholders' investment." *Id.* (emphasis in the original).

While *Hope* clearly rejected the concept that "fair value" ratemaking was constitutionally mandated, there is absolutely no support for the proposition that *Hope* replaced that standard with a new constitutional requirement that utility shareholders must receive a return of and a return on all of their investments. As one contemporary commentator characterized the holding in *Hope*:

> This disposition not only does away with reproduction cost, but also frees the Commission, or any regulatory body, from

> technical requirements in fixing reasonable rates. The end result is controlling regardless of the methods employed. No particular rate base provisions are imposed, provided that the rates as fixed are all-around "just and reasonable."

Bauer, *The Establishment And Administration Of A "Prudent Investment" Rate Base*, 53 YALE L.J. 495, 504 (1944). *See also* Drobak, *supra* at 85 n.87 ("The opinion in *Hope* even freed regulators from the constitutional requirement of using any rate base at all in setting rates.").

Subsequent to *Hope*, this Court consistently has refused to overturn rate orders or ratemaking schemes on the basis of the specific methods employed. This doctrine of judicial restraint survived its most stringent challenge in a series of cases decided by this Court which addressed the Federal Power Commission's efforts to regulate the rates of gas producers under the Natural Gas Act. In the wake of this Court's holding in *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954), that the FPC had jurisdiction over the rates charged by independent natural gas producers, the FPC was required to develop methods by which it could determine just and reasonable rates for thousands of such gas producers.

In the first decision addressing this issue, *Wisconsin v. FPC*, 373 U.S. 294, 298-99 (1963), the Court noted the FPC's "basic conclusion" that "the individual company cost-of-service method, based on theories of original cost and prudent investment, was not a workable or desirable method for determining the rates of independent producers." The Court also noted the FPC's proposed solution to this dilemma, *i.e.* the setting of "area rates" under which rates "would be established on an area basis, rather than on an individual company basis." *Id.* at 299.

In rejecting a preliminary challenge to this methodology, the Court, in an Opinion by Justice Harlan, reaffirmed the holding of *Hope* that "it is the result reached not the method employed which is controlling." *Id.* at 309. As stated by the Court:

> [T]o declare that a particular method of rate regulation is so sanctified as to make it highly unlikely that any other method could be sustained would be wholly out of keeping with this Court's consistent and clearly articulated approach to the question of the Commission's power to regulate rates.

Id.

This initial affirmation of area rates was subsequently upheld by the Court in Justice Harlan's seminal opinion in *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968). In *Permian Basin*, the Court held that there was "no constitutional infirmity" in the adoption of an area rate system for the gas produc[illegible]n the Permian Basin. Id. at 774. The Court thus approved a rate-setting process under which the specific costs of each producer were not examined.

Quite clearly, the Court found no constitutional problem in the fact that area rates might not permit some producers to recover a return of and a return on all of their prudent investments. Indeed, the primary reference to the specific costs of individual producers is found in Justice Harlan's discussion of the Commission's determination that it could permit "appropriate relief" in the event that an individual producer's "out-of-pocket expenses" exceed the producer's revenues under the area rates for a specific well. *Id.* at 770-71. While neither the Commission nor the Court identified what these "out-of-pocket" expenses included, *see id.* & n.35, they are referred to by Justice Harlan as "operating expenses." *Id.* at 771. With respect to other costs, Justice Harlan noted that the Commission emphasized that "a producer's inability to recover either its unsuccessful exploration costs or the full 12% return on its production investment would not, without more, warrant relief." *Id.*

Subsequently, in *FPC v. Texaco Inc.*, 417 U.S. 380 (1974), the Court, in an opinion by Justice White, rejected a facial attack on a proposed method for "indirect regulation" of small gas producers under the Natural Gas Act. Justice White noted that:

> Any broadside assertion that indirect regulation will

be confiscatory is premature. The consequences of indirect regulation can only be viewed in the entirety of the rate of return allowed on investment, and this effect will be unknown until the Commission has applied its scheme in individual cases over a period of time.

Id. at 392.

This principle was again confirmed in Justice Brennan's opinion for the Court in *Mobil Oil Corp. v. FPC*, 417 U.S. 283 (1974). That case involved an attack by various parties on the "area" rates established for gas producers in the Southern Louisiana area. As stated by Justice Brennan:

> Petitioner Mobil contends that the rates fixed for both flowing or first vintage gas and new or second vintage gas are too low. New York and MDG attack the rates for flowing gas as too high, but do not attack the new-gas rates. Each of the arguments is premised on a common error: that certain provisions of the order can be isolated and viewed without regard to the total effect the order is designed to achieve.

417 U.S. at 315. In responding to attacks on certain components of the area rates, Justice Brennan stated:

> Mobil's argument assumes that there is only one just and reasonable rate possible for each vintage of gas, and that this rate must be based entirely on some concept of cost plus a reasonable rate of return. We rejected this argument in *Permian Basin* and we reject it again here.

Id. at 316.

Finally, in *FERC v. Pennzoil Producing Co.*, 439 U.S. 508 (1979), the Court, per Justice White, criticized the Court of Appeals in that case for attempting to limit the discretion of the Federal Energy Regulatory Commission (FERC) in setting rates under the Natural Gas Act. While agreeing that the FERC Order regarding its ability to grant exceptions to area rate levels had to be remanded,

Justice White stated:

> We are also convinced, however, that the Court of Appeals trenched upon the ratemaking authority vested in the Commission when it strongly suggested that the Commission is required to grant the relief Producers request in this case so long as the increase in royalty costs is not imprudent and the relief, when granted, will merely sustain rather than increase Producers' profits.

Id. at 517. The Court thus flatly rejected the suggestion that a utility is entitled as a matter of constitutional law to recovery of all prudently incurred costs.

While the Appellants in the present case purport to be following the precepts of this Court set forth in *Hope* and *Permian Basin*, their facial attack on the used and useful principle can prevail only if this Court is willing to overrule the fundamental principles of judicial restraint set forth in those cases as well as in *Wisconsin, Texaco, Mobil Oil*, and *Pennzoil*. These cases uniformly stand for the proposition that no specific ratemaking method is either constitutionally required or constitutionally forbidden.

Accordingly, the Appellants' facial attack upon the used and useful ratemaking methodology must be rejected by this Court.

II. THE USED AND USEFUL STANDARD REMAINS A CONSTITUTIONALLY PERMISSIBLE RATEMAKING METHODOLOGY.

The thrust of the Appellants' attack on the used and useful principle is found at page 19 of their Brief where they state that: "The 'used and useful' test is inconsistent with the balancing of interests required by *Hope* and *Permian*." According to Appellants, the used and useful principle focuses only "on the consumer interest in receiv-

ing service at the lowest possible rate and not the range of other investor and consumer interests *in the investment at issue.*" *Id.* (emphasis added).

As with all the arguments in their Brief, the Appellants mistakenly assert here that their constitutionally protected interests in this proceeding lie in the recovery from ratepayers of the particular "investment at issue." For the reasons previously set forth in this Brief, the OCA submits that the Appellants' insistence on challenging the method employed in resolving a single item in the overall rate determination renders their appeal unsustainable under each of this Court's utility rate decisions beginning with the *Hope* case in 1944.

Nevertheless, to the extent that the Court reaches the substantive merits of the Appellants' arguments concerning the used and useful principle, the OCA submits that those arguments are also without merit. There is nothing unconstitutional or unwise about the used and useful principle either on its face or as applied in this case. The used and useful principle clearly remains constitutionally permissible under this Court's decisions in *Hope* and *Permian Basin*. Moreover, the used and useful principle is soundly based as a matter of regulatory and economic principle, and the ability of state and federal legislatures and commissions to utilize this ratemaking methodology should not be precluded by this Court.

Prior to the *Hope* decision, there was no question that a utility had no constitutional right to a return on its investment in property which was not used and useful in the service of ratepayers. Thus, in *Denver Union Stock Yard Co. v. United States*, 304 U.S. 470, 475 (1938), the Court held:

> As of right safeguarded by the due process clause of the Fifth Amendment, appellant is entitled to rates, not *per se* excessive and extortionate, sufficient to yield a reasonable rate of return upon the value of property used, at the time it is being used, to render the services. *But it is not entitled to have included any property not used and useful for that purpose.*

(citations omitted) (emphasis added).

Subsequently, the *Hope* decision recognized that it is the end result of a rate order — not the method employed in achieving that result — which determines whether a utility can challenge the order as confiscatory. In light of that ruling, it has been held that the application of the used and useful principle is not constitutionally *required* in all cases. *See Washington Gas Light Co. v. Baker*, 188 F.2d 11, 18-19 (D.C. Cir. 1950)(Bazelon, J.), *cert. denied*, 340 U.S. 952 (1951).

The question raised by Appellants in this proceeding, however, is whether the continued reliance on the used and useful principle is constitutionally *permissible* after *Hope*. The answer to that question is clearly yes. As noted by Judge Wald in one recent opinion of the United States Court of Appeals for the District of Columbia:

> Although methods for determining values of rate base items have evolved since *Smyth v. Ames*, the precept endures that an item may be included in a rate base only when it is "used and useful" in providing service. In other words, current rate payers should bear only legitimate costs of providing service to them.

Natural Gas Pipeline Co. of America v. FERC, 765 F.2d 1155, 1157 (D.C. Cir. 1985), *cert. denied*, 474 U.S. 1056 (1986), (*quoting Tennessee Gas Pipeline Co. v. FERC*, 606 F.2d 1094, 1109 (D.C. Cir. 1979), *cert. denied*, 445 U.S. 920 and 447 U.S. 922 (1980)). In another recent Opinion of that Court, Judge Starr noted that:

> For nearly a century the "used and useful" principle, enunciated by the Supreme Court in *Smyth v. Ames*, 169 U.S. 466, 18 S.Ct. 418, 42 L.Ed. 819 (1898), has stood as a bedrock principle of utility rate regulation. The principle is simple— it requires that costs associated with electric power plants be paid by the ratepayers who benefit from the plant.

Kentucky Utilities Co. v. FERC, 760 F. 2d 1321, 1324 n.4 (D.C. Cir. 1985).[3]

It is not without reason that the used and useful principle has stood for a century as the predominant method for establishing the rate base on which utility rates are set. As a matter of common sense and economic fairness, it is appropriate to charge ratepayers only for the costs of utility facilities that provide service to them. While there is substantial variation among the numerous statutory and regulatory schemes in the application of the used and useful principle, the fundamental theme of most state and federal ratemaking methodologies is that ratepayers may only be required to pay the costs of the facilities that serve them.

Moreover, there is nothing "inconsistent" between the application of the used and useful principle and theconsideration of the investor interests identified by the Court in *Hope*. In most cases — and indeed the present case provides a perfect example — the allowance of a return of and on a utility's used and useful investments is sufficient to satisfy the investor interests identified in Hope. The fact that the utility receives no *additional* compensation for non-used *and useful investments is therefore of no constitutional moment under Hope*.

[3]The Brief of Amicus Curiae Edison Electric Institute (EEI) questions not only the wisdom, but also the heritage, of the used and useful principle. At page 11, note 12, EEI observes that this Court's Opinion in *Smyth v. Ames*, 169 U.S. 466 (1898) did not actually employ the term "used and useful". Rather, EEI suggests, "somewhere along the way that apparently catchy phrase was substituted for the actual phrase employed by the Court." The OCA would note in response that one of the first of this Court's Justices to employ this "catchy phrase" was Justice Holmes in his 1903 Opinion for the Court in *San Diego Land and Town Co. v. Jasper*, 189 U.S. 439 (1903). That case involved a utility which developed excess capacity that was not needed by current customers. Rather than require existing customers to bear the full cost of that excess capacity, Justice Holmes wrote, "we should assume that only a proportionate part of the system was actually used and useful within the meaning of the statute." *Id.* at 447.

Even where the allowance of a return only on used and useful property does harm investors, however, the recognition of such an adverse impact is only the beginning, and not the end of the applicable constitutional analysis. The *Hope* decision essentially established a two-step review when a utility challenges the constitutionality of a rate order. *First*, the Court will ascertain whether the end result of the rate order produces substantial harm to investor interests. If the rate allowance permits the utility to operate successfully and to attract capital, the utility cannot claim confiscation, and constitutional review of the rate order is at an end. *Second*, if and only if the rate order results in substantial harm to investors, the Court will then examine whether such harm is justified by countervailing public policy or consumer interests.

Thus, while the Court in *Hope* recognized the investor's "legitimate concern with the financial integrity of the company," 320 U.S. at 603, the Court *prefaced* that remark by quoting the statement in its earlier opinion in *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 590 (1942), that "regulation does not insure that the business shall produce net revenues." 320 U.S. at 603. Because the appeal in *Hope* concerned only whether the *investor* interests had been adequately considered, and because the Court concluded that the "end result" in that case could not be condemned "as unjust and unreasonable *from the investor or company viewpoint*," *id.* (emphasis added), it was not necessary for the Court to set forth in detail the countervailing ratepayer interests which also must be considered. The Court thus noted that "[t]he conditions under which more or less might be allowed are not important here." *Id.*

Subsequent decisions of this Court have confirmed that there are indeed a number of instances in which "less might be allowed" than is necessary to satisfy the investor interests described in *Hope*. For example, just one year after *Hope*, the Court, in an Opinion by Justice Jackson, unanimously ruled in *Market Street Railway Co. v. Railroad Commission*, 324 U.S. 548, 567 (1945), that the reduced rates set for a failing street railway company were not confiscatory and that the company had no constitutional right to demand a return

on the value of investment "after it has vanished, even if once prudently made." In response to the company's claim that the rate order was "confiscatory by the tests of *Federal Power Commission v. Hope Natural Gas Co.*," because it did not insure the financial integrity of the enterprise, Justice Jackson responded:

> It was noted in the *Hope Natural Gas* case that regulation does not assure that the regulated business make a profit. 320 U.S. at 603; see *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575, 590. *All that was held* was that a company could not complain if the return which was allowed made it possible for the company to operate successfully.

324 U.S. at 566 (emphasis added).

Subsequently, in *Permian Basin, supra,* the Court upheld, as a matter of administrative necessity, a ratesetting procedure which was based on the *average* costs of a large number of natural gas producers and did not specifically address the investor interests in the return of or on the capital costs of individual producers. The Court in *Permian Basin* noted that, while the investor interests set forth in *Hope* remain "pertinent", they "scarcely exhaust the relevant considerations." 390 U.S. at 791.

The OCA submits that another instance in which "less might be allowed" than is necessary to satisfy investor interests is one in which a substantial portion of a utility's investments are not used and useful to ratepayers. As stated by the Pennsylvania Supreme Court in a prior decision which was unsuccessfully appealed to this Court:

> The "used and useful" principle is soundly based, for it serves to protect consumers from exploitation, and it comports with the view that, in fairness, consumers should not be required to buoy up failing utility companies by being required to, in effect, provide public subsidies for utility properties that are not useful in the public service. If the *Hope* decision were to be interpreted as providing constitutional guarantees for the achievement of investor interests, the "used and useful" principle would have to yield, at least in exceptional situations where the financial integrity of a utility is imperiled, but we do not perceive from *Hope* that investor interests are to be accorded such a guaranteed status.

Pennsylvania Electric Co. v. Pennsylvania Public Utility Commission, 509 Pa. 324, 333-34, 502 A.2d 130, 135 (1985), *appeal dismissed sub nom. Metropolitan Edison Co. v. Pennsylvania Public Utility Commission,* 476 U.S. 1137 (1986). The utilities' appeal of that decision to this Court was dismissed for lack of a substantial federal question.

While the used and useful principle typically is applied to cases involving the "rate base", or the investment *on* which the utility may charge a return, it can also be applied to questions involving the return *of* capital in investments which do not serve ratepayers. Thus, for example, in the recent D.C. Circuit *Natural Gas Pipeline* case noted above, the Court upheld the Federal Energy Regulatory Commission's denial of the recovery *of* the pipeline company's investment in three unsuccessful gas supply projects. 765 F.2d at 1156. Even though the company did not seek to earn a return *on* this investment, the Court affirmed FERC's denial of recovery of the costs, based on FERC's rationale that "the expenditures were not used and useful to ratepayers." *Id.* at 1158.

Similarly, in the present case, the Pennsylvania Supreme Court recognized that the utilities could not recover their investments in non-used and useful facilities simply by "converting them into operating expenses through amortization." 532 A.2d at 332. (App. 15a). This interpretation is, of course, consistent with the express language of the section of the Pennsylvania Public Utility Code at issue, which states that the costs of non-used and useful facilities "shall not be made a part of the rate base nor otherwise included in the rates charged by the electric utility."

While a number of regulatory jurisdictions have determined, as a matter of ratemaking *policy*, that the costs of abandoned plants may be recovered from ratepayers, utilities have no *constitutional* right to a return *on or* a return *of* investment in plant which is not used and useful to ratepayers.[4]

In summary, the OCA submits that the used and useful principle remains constitutionally permissible after *Hope*. In the present case, the application of the used and useful principle does not even call into question the investor interests which are considered under *Hope*. Even where these investor interests do clash with the used and useful principle, however, *Hope* does not require that the investor interests be satisfied in all cases.

Hope recognized that regulation does not insure that a utility will produce net revenues. 320 U.S. at 603. One instance in which it is possible that net revenues need not be insured by the ratepayers is where the utility's investments, for whatever reason, fail to provide used and useful service to those ratepayers.

[4]Appellants suggest at page 30-31 of their Brief that the Court in *Hope* drew a constitutional distinction between the return *on* investment and the return *of* investment through depreciation. 320 U.S. at 606. This interpretation of *Hope* is incorrect and is indeed contrary to the fundamental holdings of that case. The Court in that section of the *Hope* decision merely rejected the company's argument that the FPC had erred by establishing the depreciation allowance on the basis of original cost, and found that "[n]o more is required." *Id.* The Court certainly did not suggest that the utility could recover depreciation on non-used and useful investment. Indeed, the Court referenced a provision of the Natural Gas Act which permitted the FPC to establish depreciation rates for "the several classes of property of each natural-gas company *used or useful* in the production, transportation, or sale of natural gas." *Id.* at 606 n.12 (emphasis added).

III. THE PENNSYLVANIA GENERAL ASSEMBLY IS NOT BARRED FROM REQUIRING THE PENNSYLVANIA PUBLIC UTILITY COMMISSION TO EXCLUDE THE COSTS OF CERTAIN NON-USED AND USEFUL INVESTMENTS IN SETTING JUST AND REASONABLE RATES.

In addition to questioning the general wisdom and constitutionality of the used and useful principle, the Appellants contend that it is particularly inappropriate to apply such a principle as a matter of law. Such a *per se* application of this principle, according to Appellants, "unconstitutionally precludes the PUC from considering factors pertinent to the balance between investor and consumer interests." Appellants' Brief at 23. Relying primarily on Justice Harlan's discussion of judicial review in *Permian Basin*, 390 U.S. at 790-92, the Appellants contend that, under the Pennsylvania Supreme Court's interpretation of the statute at issue here, the PUC

> is constrained to produce a rate order that does not reflect a balance of investor and consumer interests *with respect to the Duquesne and Penn Power investment in the four CAPCO units.*

Appellants' Brief at 25-26 (emphasis added).

Once again, the Appellants misconstrue *Hope* and *Permian Basin* when they suggest that their constitutionally protected interests are in particular investments. In fact, as a review of the rate orders at issue plainly demonstrates, the recovery of the costs at issue here was only one of a large number of issues that produced the overall rate levels authorized in this case. *See* Appellants' Appendix C and E.

The challenged legislation affects only a part of the Commission's overall determination of just and reasonable rates. Indeed, the "just and reasonable" standard, which Appellants claim is violated by the Pennsylvania ratemaking scheme, remains the fun-

damental overriding element of all ratemaking determinations in Pennsylvania under both statutory and case law. 66 Pa. Cons. Stat. §1301 (1987); *Pennsylvania Public Utility Commission v. Pennsylvania Gas and Water Co.*, 492 Pa. 326, 337, 424 A.2d 1213, 1219 (1980), *cert. denied*, 454 U.S. 824 (1981).

Moreover, the OCA submits that Appellants seriously misconstrue this Court's *Permian Basin* holding, as well as the entire theory of legislative delegation, when they suggest that the Pennsylvania ratemaking scheme is constitutionally deficient because it is too specific. *Permian Basin* does not hold that the overall authority of a commission to set just and reasonable rates cannot be circumscribed by the legislative body from which the commission's powers are derived. Rather, Justice Harlan noted in that case that the commission

> must be free, *within the limitations imposed by pertinent constitutional and statutory commands*, to devise methods of regulation capable of equitably reconciling diverse and conflicting interests.

390 U.S. at 767 (emphasis added). Justice Harlan added that

> rate-making agencies are not bound to the service of any single regulatory formula; they are permitted, *unless their statutory authority otherwise plainly indicates*, "to make the pragmatic adjustments which may be called for by particular circumstances."

Id. at 776-77 (citation omitted) (emphasis added).

Certainly, Justice Harlan did not suggest that Congress *could not* have enacted more specific standards in the Natural Gas Act than the just and reasonable standard. Rather, he recognized that Congress *did not* enact such standards. He therefore set forth the considerations which the FPC was required to address in order to permit proper judicial review of its orders under the broad just and

reasonable standard. *Id.* at 790-92.

This interpretation of the relative standing of the legislature and its designated administrative arm is consistent with the discussion of this issue by Justice Douglas in an opinion which he authored for the Court shortly after the Hope decision. In *Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581 (1945), Justice Douglas upheld an FPC cost allocation methodology, and noted that:

> When Congress, as here, fails to provide a formula for the Commission to follow, courts are not warranted in rejecting the one which the Commission employs unless it plainly contravenes the statutory scheme of regulation. *If Congress had prescribed a formula it would be the duty of the Commission to follow it.*

324 U.S. at 589 (emphasis added).

In the Natural Gas Act, Congress established the statutory standard of just and reasonable rates and thus left the Federal Power Commission with substantial discretion in setting those rates. In Pennsylvania, the General Assembly has also established the overriding requirement that rates must be just and reasonable, 66 Pa. Cons. Stat. §1301 (1987), but has "plainly indicated" to the Public Utility Commission that in setting such rates, the Commission must exclude recovery of costs of certain non-used and useful assets. 66 Pa. Cons. Stat. §1315 (1987).

Under the Appellants' apparent view of public utility regulation, the ratemaking chapters of the public utility codes of each of the 50 states would be allowed to consist of only one sentence: "Rates must be just and reasonable." Like many state legislatures, however, the Pennsylvania General Assembly has not chosen to issue a one-sentence long Public Utility Code. Rather, the General Assembly has gone on to provide specific substantive and procedural directives which must be followed by the Public Utility Commission in setting just and reasonable rates. These provisions do not attempt to repeal the overriding statutory and constitutional requirement that overall

rate levels must be just and reasonable; rather, they provide specific instructions on how certain sub-issues must be addressed in making that ultimate rate determination. While the General Assembly theoretically could have granted its administrative ratemaking arm absolute discretion in setting rates under the just and reasonable standard, it has chosen not to do so. There is certainly nothing constitutionally defective about this choice, particularly since the Pennsylvania Public Utility Code retains the just and reasonable standard as its overriding rate requirement.

Indeed, it would be a curious ruling for this Court to hold that, as a matter of constitutional law, an administrative agency must have broader discretion than the legislative body which creates it. Public utility commissions are nothing more than administrative arms of the state legislatures which create them. As stated by the Pennsylvania Supreme Court in the present case:

> It is clear, beyond any need for citation, that the function of ratemaking for public utilities is legislative in nature. The Commission is but an instrumentality of the state legislature for the performance of that function; and the agency has only such powers as are expressly conferred upon it by statute or exist by necessary implication.

532 A.2d at 339. (App. 30a). *See also Minnesota Rate Cases*, 230 U.S. 352, 433 (1913) ("The rate-making power is a legislative power and necessarily implies a range of legislative discretion. We do not sit as a board of revision to substitute our judgment for that of the legislature, or of the commission lawfully constituted by it, as to matters within the province of either.")[3]

[3]Indeed, for a great part of this Court's history, the issue of constitutional concern was the exact opposite of the one raised by Appellants here. That is, challenges to state and federal laws were raised on the ground that the legislatures had delegated too *much* authority and discretion to administrative agencies. This Court held, however, that:

> If Congress shall lay down by legislative act an intelligible principle to which the person or body authorized to fix such rates is directed to conform, such legislative action is not a forbidden delegation of legislative power.

J.W. Hampton, Jr. & Co. v. United States, 276 U.S. 394, 409 (1928).

Since the state legislatures could (and, in many cases, once did) set rates in their jurisdictions themselves, it is certainly within their powers to provide specific statutory directions to the commissions they have created to carry out those duties. Unless such specific legislative directions necessarily preclude the setting of just and reasonable rates on an overall basis, they cannot be found, in and of themselves, to be unconstitutional.

Again, when the Appellants claim that Section 1315 precludes the Commission "from balancing investor and consumer interests when considering a utility's investment in cancelled electric generating units," Brief at 24, they misstate the entire premise of constitutional review of ratemaking determinations since *Hope*. The duly elected General Assembly of Pennsylvania has prescribed the ratemaking treatment for this one issue as a matter of state public policy. The *constitutional* question is whether such a provision necessarily results in confiscatory overall rates. For the reasons set forth above, the OCA submits that it does not.

Similarly, the Appellants' argument that the PUC Orders below "reflect a balancing of investor and consumer interests," Brief at 20-23, is not of any constitutional significance. Even if true, the argument fails for the reasons set forth by Justice Brennan in *Mobil Oil, supra*, 417 U.S. at 316. Like Mobil Oil in that case, the Appellants here seem to assume "that there is only one just and reasonable rate." Here, one aspect of the original rate order has been found by the Pennsylvania Supreme Court to be erroneous as a matter of Pennsylvania state law, and the matter has been remanded to the PUC for further proceedings consistent with that finding. The correction of that error need not jeopardize the investor interests identified by the Court in *Hope*. *See* Section IB, *supra*. Even if it did, however, such a determination would not necessarily be impermissible in light of the public policy considerations embodied in the General Assembly's action.

Finally, the Appellants' argument at page 24, note 20, that the challenged legislation violates substantive due process standards is wholly without merit. The basis for the Appellants' argument on this

point appears to be the fact that the Pennsylvania Public Utility Code was amended in 1985 to permit recovery of certain costs incurred on power plants cancelled after the effective date of that amendment. The Appellants claim that the "interplay" between the provision here at issue and the amended legislation is "arbitrary and irrational" and thus violative of the Due Process Clause of the Fourteenth Amendment. In essence, the Appellants are arguing that it is unconstitutional for the state legislature to change a law.

The OCA submits that Section 1315 of the Public Utility Code obviously passes the standards for review of economic legislation established by this Court in *Nebbia v. New York*, 291 U.S. 502 (1934) and consistently observed by the Court since that time. *See, e.g., Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 729 (1984); *Schweiker v. Wilson*, 450 U.S. 221, 230 (1981); *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 15 (1976); *Ferguson v. Skrupa*, 372 U.S. 726, 730-31 (1963); *Williamson v. Lee Optical, Inc.*, 348 U.S. 483, 487-488 (1955). As stated by the Court in *Nebbia*:

> Price control, like any other form of regulation, is unconstitutional only if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt, and hence an unnecessary and unwarranted interference with individual liberty.

291 U.S. at 539.

Section 1315 of the Public Utility Code clearly embodied a legislative policy determination that ratepayers should not be required to bear the costs of certain useless utility investments. As noted by the Pennsylvania Supreme Court in this case, this legislation essentially codified long-standing principles of Pennsylvania public utility law. 532 A.2d 325, 338 (App. 29a). The policy behind that legislation, *i.e.* the used and useful principle, has been held by the Pennsylvania Supreme Court to be "soundly based, for it serves to protect consumers from exploitation." *Pennsylvania Electric*

Co., supra, 509 Pa. at 333, 502 A.2d at 135.[6]

While a strict application of the used and useful principle has a sound basis, however, it is not constitutionally required in all cases. Thus, the Pennsylvania Supreme Court in the present case ruled that, under Pennsylvania law,

> it should be clear that no utility of any type is permitted, *without express and valid legislative authorization*, to charge ratepayers for property which is not used and useful in the production of current utility service.

532 A.2d 338 (App. 28a-29a) (emphasis added). Section 520, the 1985 amendment to the Public Utility Code which is addressed by Appellants in their Brief, was an express legislative exception to the strict application of the used and useful principle which had been codified in Section 1315.

The OCA submits that Sections 1315 and 520 represent two policy determinations by the Pennsylvania General Assembly. Both views are constitutionally permissible and both can be applied consistently with the overriding requirement of Section 1301 of the Pennsylvania Public Utility Code that all rates must be just and reasonable. The statutory change which gave rise to these different results was neither arbitrary nor irrational, but rather illustrates the proper exercise of public policy determinations by a state legislature. In considering the public interest, as well as the interests of ratepayers and investors, the General Assembly determined that it was appropriate to create a prospective exception in Section 520 to the general rule of Section 1315 against the inclusion in rates of the costs of non-used and useful investment.

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[6]This Court recently rejected a due process clause challenge to a rent control law in *Pennell v. City of San Jose*, 108 S.Ct. 849, 857-58 (1988). After citing the standards for review of economic regulation set forth in *Nebbia* and *Permian Basin*, the Court, in the Opinion by Chief Justice Rehnquist, noted that "we have long recognized that a legitimate and rational goal of price or rate regulation is the protection of consumer welfare." *Id.* at 858.

Neither Section 1315 nor the "interplay" between Sections 1315 and 520 is arbitrary or irrational. On the contrary, these provisions represent the type of legislative policymaking which states must be free to perform and which this Court has refused to disturb for the last 50 years. It would be extraordinary, to say the least, if this Court were to hold that changes in legislative policies are inherently unconstitutional. The Appellants' due process claim is without merit and must be rejected by this Court.

IV. THE DENIAL OF RECOVERY OF THE COSTS AT ISSUE HERE DID NOT EFFECT A "TAKING" OF THE APPELLANTS' PROPERTY.

Appellants' final argument, at pages 26-33 of their Brief, is that the challenged legislation, as interpreted by the Pennsylvania Supreme Court in this case, is *per se* unconstitutional because it "frustrates the reasonable expectations of utility investors and prevents them from being compensated for their prudent investment dedicated to public use." Brief at 26.

The Appellants thus appear to base their last argument on this Court's traditional "takings" jurisprudence and, in particular, the question of whether governmental conduct unduly interferes with "reasonable investment-backed expectations." Brief at 27, *citing Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1975).

Before addressing the merits of the Appellants' confiscation claim, it is necessary to ask: what has been "taken" in this case and by whom?

The Appellants continually assert that their investments in the four cancelled plants have been taken as a result of the order in this case. Yet, there is no dispute that the Appellants, and their Ohio utility partners, voluntarily cancelled these projects and *then* came to their respective public utility commissions for recovery of costs of these now worthless investments.

No government action was responsible for the total elimination of the value of these investments. It is therefore not at all clear why the government — or, more precisely, the ratepayers of these ...ities through the regulatory action of the PUC — must "compensate" the utilities for the lost value.

These investments are thus comparable to the assets in *Market Street Railway, supra*, whose value had "vanished." 324 U.S. at 567. As noted by Justice Jackson in that decision, while the due process clause has been applied "to prevent governmental destruction of existing economic values," it cannot be used "to restore values that have been lost by the operation of economic forces." *Id.*

The issue of when a "taking" occurs in the utility ratemaking context was addressed by Judge Starr in his concurring opinion in *Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168, 1189-94 (D.C. Cir. 1987). *See also*, Drobak, *supra*, at 98-112. As noted by Judge Starr:

> [A] taking does not occur when financial resources are committed to the enterprise. That is especially so since a utility's capital investment is made not simply in satisfaction of legal obligations to provide service to the public but in anticipation of profits on the investment. The utility is not a servant to the state; it is a for-profit enterprise which incurs legal obligations in exchange for state-conferred benefits.

810 F.2d at 1189.

In the present case, Appellants argue that they incurred these investment costs pursuant to their statutory obligation to provide service to their ratepayers. They fail to note, however, that this obligation to serve is the *quid pro quo* for the utilities' monopoly franchise to provide electric service to those customers. Moreover, they fail to acknowledge that a general obligation to serve does not specify how those obligations are to be met at any given time. As stated by Judge Starr:

> [G]overnment forced upon the utility an obligation to provide service, but that obligation, as we have seen, is the *quid pro quo* for a protected area of service (and eminent domain authority). What is fundamental is that government did not force upon the utility a specific course of action for achieving the mandated goal.

Id. at 1190.

Certainly, Judge Starr's description of the regulatory process is applicable here. Duquesne and Penn Power do in fact have an obligation to serve their customers, but they also have monopoly franchises which prohibit any other parties from providing retail electric service in their respective service territories. Moreover, these companies can meet their service obligations in any number of ways — including the construction of new capacity of all sizes and fuel types, the purchase of power from neighboring utilities, the purchase of power from independent cogenerators and small power producers, or the implementation of conservation and load management programs. Suffice it to say that Duquesne and Penn Power were never ordered by any governmental authority to start construction on these four plants, and they were never ordered to cancel them.

Turning to the specific analysis of the Appellants' confiscation claim, this Court's jurisprudence teaches us that a takings claim will be examined through "essentially ad hoc, factual inquiries" which address such factors as 1) the economic impact of the regulation; 2) the nature of the government action; and 3) the extent to which the regulation has interfered with investor-backed expectations. *Penn Central Transportation Co. v. New York City*, 438 U.S. 104, 124 (1978); *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 432 (1982). For example, the Court has held that a taking "may more readily be found when the interference with property can be characterized as a physical invasion by government", *Penn Central, supra,* at 124, whereas, the "loss of future profits—unaccompanied by any physical property restriction—provides a slender reed upon which to rest a takings claim." *Andrus v. Allard*, 444 U.S. 51, 66 (1979).

First, with respect to the economic impact of the Order under appeal, the OCA has previously noted the relatively minor nature of the disallowance here at issue. *See* Section IB, *supra*. This factor is particularly important in the ratemaking context because the initial test for confiscation revolves around overall rates, not the specific items comprising those rates. This view is also consistent with this Court's other takings cases, which compare the value of what is allegedly taken to the value of the *entire* property at issue. *See Penn Central, supra,* 438 U.S. at 131 ("'Taking' jurisprudence does not divide a single parcel into discrete segments and attempt to determine whether rights in a particular segment have been entirely abrogated."); *Keystone Bituminous Coal Association v. DeBenedictis,* 107 S.Ct. 1232, 1248 (1987) (citation omitted) ("Because our test for regulatory taking requires us to compare the value that has been taken from the property with the value that remains in the property, one of the critical questions is determining how to define the unit of property 'whose value is to furnish the denominator of the fraction.'")

In the present Duquesne case, for example, if one views the "denominator" as the Company's total allowable revenues of over $800 million per year (App. 126c), the approximate $3.4 million reduction in those revenues which would result from the disallowance represents less than one half of one percent of the total. The percentage for Penn Power is comparable. Moreover, neither Appellant has alleged that this disallowance will have a significant negative impact on their overall rates or financial condition.

With respect to the second prong of this Court's takings analysis, the nature of the government action here could hardly be less intrusive. The utilities came to the government (in the form of the Pennsylvania Public Utility Commission) and asked for compensation for an investment rendered worthless by the utilities' own voluntary actions. There was certainly no physical intrusion and the Appellants weren't ordered to do anything.

Finally, with respect to investor-backed expectations, the OCA submits that if investors expected recovery of these specific

costs, they had no basis for such expectations under either Pennsylvania or federal law.

Thus, while Appellants state that "[t]he reasonable expectations of utility investors requires recovery, *per se*, of a utility's prudent investment in cancelled electric generating units," Brief at 26, the Appellants fail to cite a single Pennsylvania case or statute which would have given rise to such expectations. Quite to the contrary, the Pennsylvania Supreme Court Order, which is authoritative with respect to matters of state law, (*see Brinkerhoff-Faris Trust & Savings Co. v. Hill*, 281 U.S. 673, 680-81 (1930); *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 160 (1980)), specifically noted that the used and useful principle is one of the "cardinal principles of this state's public utility law," citing cases dating back to 1921 and 1924, 532 A.2d at 334-335 (App. 19a-20a). The Court further held that:

> Given what we have already said about the fundamental principles of this state's public-utility jurisprudence, it should be clear that no utility of any type is permitted, without express and valid legislative authorization, to charge ratepayers for property which is not used and useful in the production of current utility service.

532 A.2d at 338 (App. 28a-29a). Certainly, the Appellants have cited no express legislative authorization for recovery of the costs at issue here.

Similarly, while the Appellants might prefer to see the "prudent investment" standard established as the constitutionally required law of the land, the D.C. Circuit Court of Appeals has correctly noted that "the 'prudent investment' approach has *never* been adopted by the Supreme Court as the sole method of rate base determination." *Communications Satellite Corp. v. FCC*, 611 F.2d 883, 890 (D.C. Cir. 1977) (emphasis in the original).

This Court has recognized that investor expectations based on inaccurate interpretations of the law are not protected by the takings

clause. *See Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1005-10 (1984); *Webb's Fabulous Pharmacies, Inc., supra*, 449 U.S. at 161 ("[A] mere unilateral expectation or an abstract need is not a property interest entitled to protection.") *See also* Drobak, *supra*, at 108 (footnote omitted) ("[E]ven if utility investors incorrectly perceive that the Constitution entitles them to profits that fulfill the investor interest of *Hope*, the Supreme Court would find that expectation to be unreasonable and therefore unprotected by the takings clause.")

The Appellants' confiscation claim in this case thus satisfies none of the standards for establishing an unconstitutional taking and should therefore be rejected.

V. THE COURT SHOULD REJECT THE ARGUMENTS OF THE APPELLANTS AND THE AMICI CURIAE THAT THE "PRUDENT INVESTMENT" TEST EITHER HAS BEEN OR SHOULD BE ADOPTED AS THE SOLE CONSTITUTIONALLY PERMISSIBLE RATEMAKING STANDARD.

While the Appellants suggest that utility investors have a constitutionally protected interest in recovery of all prudent investment, *see* Brief at 26-27, they stop short of suggesting that investors must also be guaranteed a return on that investment as well. *See* Brief at 27, note 21. The Brief of Pennsylvania Electric Association (PEA), as Amicus Curiae in support of Appellants, however, is not so restrictive in its approach.

PEA argues that the Court should adopt as the sole constitutional benchmark for utility ratemaking decisions a "prudent investment" standard which PEA attributes to Justice Brandeis in his concurring opinion in *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276, 289-312 (1923). The OCA submits that the PEA has misinterpreted the import of Justice Brandeis' *Southwestern Bell* concurrence as well as the manner in which the *Hope* decision relied upon that concurrence. PEA's proposed standard has been consistently rejected in the past and should be rejected by the Court in this case. As set forth below, it

is OCA's position that this Court should not adopt the prudent investment standard — or for that matter, any single standard — as the sole constitutionally permissible ratemaking methodology.

When Justice Brandeis set forth his "prudent investment" standard in *Southwestern Bell*, he was writing in opposition to the "fair value" standard of ratemaking in which the courts had insisted that utility investors had a constitutional right to earn a fair return on the "fair value" of their utility investments. The fair value requirement was based on an eminent domain theory of ratemaking and required that utility investors be compensated — as in an eminent domain proceeding — for the current value, not simply the original cost, of their utility investments.

What Justice Brandeis, and a number of contemporary commentators recognized, was that the fair value standard was hopelessly circular, in that the "value" of utility property was determined by the rates allowed to support the property, and yet the rates were purportedly being set on the basis of that value. Moreover, methods of determining fair value, through such means as ascertaining the "reproduction cost" of recreating all the utilities' existing facilities at current prices, were highly unstable and difficult, if not impossible to verify in a meaningful manner. *See Southwestern Bell*, 262 U.S. at 292-298; Hale, *Utility Valuation: Does The Ghost Of Smyth v. Ames Still Walk?*, 55 HARV. L. REV. 1116 (1942); Bonbright, *The Problem Of Valuation: The Economic Merits Of Original Cost And Reproduction Cost*, 41 HARV. L. REV. 593 (1928).

Justice Brandeis argued that it was not the fair value of specific utility investments that was properly at issue, but rather the capital prudently invested in those facilities by the owners of the utilities.

OCA submits, however, that Justice Brandeis' prudent investment standard was *not* intended to stand *in opposition to* the used and useful principle. Rather, Justice Brandeis and other critics of fair value were concerned with the method of *valuation* used to determine the rate base on which investors could earn a return. It is a

mistake to assume that Justice Brandeis' prudent investment rule was intended to apply to everything in which a utility invested, without regard to whether or not that investment was used to provide utility service. Thus, for example, Justice Brandeis noted in the Southwestern Bell concurrence that "*so long as the specific items of property are employed by the utility*, their exchange value is not of legal significance." 262 U.S. at 290 (emphasis added). Moreover, in a footnote to his concurrence, Justice Brandeis equated "prudent investment" with "historical cost", which he defined as follows:

> Historical cost, on the other hand, is the amount which normally should have been paid for all the property *which is usefully devoted to the public service*. It is, in effect, what is termed the prudent investment.

262 U.S. at 295 n.6 (emphasis added). Justice Brandeis contrasted this definition of prudent investment with "actual cost" under which "there is no attempt to determine whether the expenditure was wise or foolish, *or whether it was useful or wasteful.*" *Id.* (emphasis added).[7]

Far from condemning the used and useful principle, therefore, the prudent investment theory as articulated by Justice Brandeis would appear to incorporate that principle as an appropriate element. Certainly, there is nothing in Justice Brandeis' concurrence which suggests that he believed utility investors had a constitutionally protected right to a return of or on investment in property which was not "usefully devoted to the public service."

More importantly, what this Court subsequently adopted in the *Hope* decision was not Justice Brandeis' "prudent investment" standard *per se*, but rather the rejection of the "fair value" standard which Justice Brandeis had so eloquently challenged. In rejecting

[7]Another proponent of the prudent investment standard defined his proposed "prudent investment" rate base as "the original cost of the properties used in public service, less the part of such cost which is applicable to past use." *Bauer, supra*, at 506.

fair value, however, the *Hope* case adopted no single constitutional standard to replace it. Indeed, *Hope* rejected the entire eminent domain analogy and recognized that ratemaking was an exercise of the police power which could, if necessary, "reduce the value of the property which is being regulated." 320 U.S. at 601. *See* Drobak, *supra*, at 85 n.87 ("The Court [in *Hope*] did not choose the prudent investment standard over reproduction cost. Rather, it left the regulatory commissions the option of choosing whatever methodology they preferred, so long as the constitutional test of *Hope* was satisfied.")

To the extent that utilities have argued in subsequent cases that the "prudent investment" test has or should replace the used and useful principle as a matter of constitutional law, this argument has been rejected. *See, e.g., Communications Satellite Corp.v. FCC*, 611 F.2d 883, 890 (1977); *NEPCO Municipal Rate Committee v. FERC*, 668 F.2d 1327, 1333 (D.C. Cir. 1981), *cert. denied*, 457 U.S. 1117 (1982); *Democratic Central Committee v. Washington Metropolitan Area Transit Commission*, 485 F.2d 786, 801 (D.C. Cir. 1973), *cert denied sub nom. D.C. Transit System, Inc. v. Democratic Central Committee*, 415 U.S. 935 (1974).

Amicus PEA cites no cases which have held that utilities have a constitutional right to a return of and on all expenditures that are not found to be imprudent. In contrast, OCA submits that numerous state and federal regulatory commissions and courts have recognized the continuing validity of the used and useful principle as a constitutionally permissible and economically sound ratemaking method.[8]

[8]In addition to the Pennsylvania Supreme Court and D.C. Circuit Court decisions noted above, *see, e.g., Dayton Power & Light Co. v. Public Utilities Commission*, 4 Ohio St.3d 91, 447 N.E.2d 733, 743 (Ohio 1983); *Citizens Action Coalition, Inc. v. Northern Indiana Public Service Co.*, 485 N.E.2d 610, 614-15 (Ind. 1985), *appeal dismissed and cert. denied*, 476 U.S. 1137 (1986); *Iowa-Illinois Gas and Electric Co. v. Iowa State Commerce Commission*, 412 N.W. 2d 600, 605 (Iowa 1987); *Lone Star Gas Co. v. Oklahoma*, 745 P.2d 723, 729 (Okla.

(Footnote continued on following page)

The OCA submits that one reason that the used and useful principle has continued to stand as the primary ratemaking principle in so many jurisdictions is that, as a practical matter, it makes sense.

It is well and good to pronounce that utilities must be allowed to earn a return of and on all of their "prudent investment," but the question cries out to be answered in the context of a rate proceeding: *prudent investment in what?*

If a utility makes an investment in a project of an unregulated subsidiary, should ratepayers be forced — as a matter of constitutional law — to pay a return of or on suchan investment? No, that investment is not used and useful to those ratepayers.

If Penn Power's parent company, Ohio Edison, makes an investment in a plant to serve Ohio ratepayers, must Penn Power ratepayers pay for it? No, it is not used and useful to Penn Power ratepayers.

What if Penn Power makes an investment to serve its wholesale customers, which are served under its Federal Energy Regulatory Commission jurisdiction? The used and useful principle assures that the ratepayers of each jurisdiction bear only the costs for which they are responsible.

And finally, what if a utility makes an investment which fails to provide service to anyone? The used and useful principle protects ratepayers from paying for this investment in *addition* to the investments which do provide service.

(Footnote continued from previous page)

1986); *Re Public Service Co.*, 125 N.H. 46, 480 A.2d 20, 23-24 (N.H. 1984); *Senior Citizens Coalition v. Minnesota Public Utilities Commission*, 355 N.W. 2d 295, 300 (Minn. 1984); *Allain v. Mississippi Public Service Commission*, 435 So. 2d 608, 613 (Miss. 1983); *Pacific Power & Light Co. v. Public Service Commission*, 677 P.2d 799, 805 (Wyo. 1984), *cert. denied*, 469 U.S. 831 (1984); *Committee of Consumer Services v. Public Service Commission*, 595 P.2d 871, 874 (Utah 1979), *cert. denied*, 444 U.S. 1014 (1980); *In re Petition of Jersey Central Power and Light Co.*, 85 N.J. 520, 428 A.2d 498, 502 (N.J. 1981).

The OCA reiterates that it does *not* contend that the used and useful principle is constitutionally *required*. Many states, as a matter of law or policy, have permitted exceptions to the strict application of the used and useful principle. Indeed, Section 1315, the provision of the Pennsylvania Public Utility Code at issue here, exempts investments in such items as pollution control and safety-related facilities from the used and useful requirement. 66 Pa. Cons. Stat. §1315 (1987). The Pennsylvania Public Utility Code has now even been amended to permit recovery of certain cancelled plant costs — a provision which has enabled Duquesne to begin recovery of its $154 million share of its recently abandoned Perry 2 plant. 66 Pa. Cons. Stat. §520 (1987). *See* OCA Motion to Dismiss or Affirm at 50-52. These are matters of public policy, however, not constitutional law.

In his concurring opinion in *Jersey Central, supra,* 810 F.2d at 1190-91, Judge Starr criticized the sole reliance on *either* the prudent investment *or* the used and useful standard without regard to the overall balance of interests of investors and ratepayers in establishing just and reasonable rates. Judge Starr's analysis of these two standards is instructive, however, in demonstrating why it is not appropriate to adopt a single constitutionally mandated ratemaking policy. As noted by Judge Starr:

> Prudence is, of course, relevant to the process of striking a reasonable balance in rate-setting for public utilities. Requiring an investment to be prudent when made is one safeguard imposed by regulatory authorities upon the regulated business for benefit of ratepayers. As I see it, the "used and useful" rule is but another such safeguard. The prudence rule looks to the time of investment, whereas the "used and useful" rule looks toward a later time. The two principles are designed to assure that the ratepayers, whose property might otherwise of course be "taken" by regulatory authorities, will not necessarily be saddled with the results of management's defalcations or mistakes, or as a matter of simple justice, be required to pay for that which provides the ratepayers with no discernible benefit.

> The two principles thus provide assurances that ill-guided management or management that simply proves in hindsight to have been wrong will not automatically be bailed out from conditions which government did not force upon it.

Id. at 1190 (footnote omitted). Judge Starr further noted that:

> The obvious danger in not examining both ends of the continuum—both the prudence of the investment and whether the end result of the investment was used and useful—is to build in pressures for building excess generating capacity. The "used and useful" rule operates as a restraining principle, reminding utility managers that they must assume the risk of economic forces working against an investment which is prudent at the time it is made.

Id. at 1190 n.1.

This Court has recognized that "the regulation of utilities is one of the most important of the functions traditionally associated with the police power of the States." *Arkansas Electric Cooperative Corp. v. Arkansas Public Service Commission,* 461 U.S. 375, 377 (1983). Different states have chosen different methods of allocating the risks and costs of utility facilities between investors and ratepayers. It would be extremely disruptive to the states' legislative and regulatory processes if this Court were to reject the teachings of *Hope*, and impose a single constitutionally mandated ratemaking methodology. In addition, such a ruling could plunge this Court, as well as other state and federal appellate courts, into the position of reviewing every element of every utility rate order on a constitutional basis. After all, if utilities have a constitutional right to a fair return on all of their prudent investments, then *every* rate disallowance arguably would have a constitutional dimension since every disallowance affects the investors' ultimate level of return.

The OCA respectfully urges this Court to refrain from imposing a single constitionally mandated ratemaking standard on all state and federal regulatory authorities. To impose such a standard would

be to return this Court to the pre-Hope era, where every ratemaking disallowance raised constitutional issues and the state and federal regulatory agencies were paralyzed in their attempts to set rates in a fair and economically efficient manner.

By insisting on the utilities' constitutional right to a return of and on individual items of property, the Appellants and their Amici would effectively re-establish the eminent domain theory of ratemaking, with one important modification. That is, the property on which they demand compensation in this case is absolutely worthless.

There is no basis in law for utilities to claim a constitutionally guaranteed right to either a return of or a return on useless investments. The prudent investment standard proposed by the Appellants and Amici should be rejected.

CONCLUSION

Near the end of the *Hope* Opinion, Justice Douglas observed that, if the rates upheld in that case proved to be inadequate, "the doors of the Commission are open for increased allowances." 320 U.S. at 615.

As the ratepayers of Duquesne Light Company and Pennsylvania Power Company have become painfully aware, the doors of the Pennsylvania Public Utility Commission are open as well. During the last decade, both Duquesne and Penn Power have been before the Commission with numerous rate increase requests. Those requests culminated in the last several months with phased rate increases totalling $232 million, or 29 percent, for Duquesne, and $67 million, or 38 percent, for Penn Power.[9]

The *Hope* decision put an end to the era in which utilities could come to this Court demanding constitutional protection for

[9] *Pa. PUC v. Duquesne Light Co.*, R-870651 (Pa. PUC March 25, 1988); *Pa. PUC v. Pennsylvania Power Co.*, R-870732 (Pa. PUC May 3, 1988).

specific rate claims or insisting upon the application of certain ratemaking methodologies. Under *Hope*, if the overall rates permit the utility to operate successfully, then constitutional review — from the utility investor viewpoint — is at an end. If the utility would like to operate even more successfully, "the doors of the Commission are open for increased allowances" if such allowances are found to be lawful and appropriate.

The Appellants here have not met the threshold requirements for raising a confiscation claim under Hope. Even if they had, however, the OCA submits that the Pennsylvania ratemaking policy and statute at issue here are constitutionally permissible and economically sound.

The Opinion and Order of the Pennsylvania Supreme Court here on appeal must therefore be affirmed.

Respectfully submitted,

David M. Barasch
Consumer Advocate
Irwin A. Popowsky*
Daniel Clearfield
Debra M. Kriete
Kent D. Murphy
Assistant
Consumer Advocates

Commonwealth of Pennsylvania
Office of Attorney General
Office of Consumer Advocate
1425 Strawberry Square
Harrisburg, Pennsylvania 17120
(717) 783-5048

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*Counsel of Record

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In The Supreme Court of the United States

OCTOBER TERM, 1987

DUQUESNE LIGHT COMPANY
AND
PENNSYLVANIA POWER COMPANY
Appellants,

v.

DAVID M. BARASCH,
CONSUMER ADVOCATE, et. al.
Appellees.

On Appeal from the Supreme Court of Pennsylvania

REPLY BRIEF FOR APPELLANTS

ALAN L. REED
WILLIAM E. ZEITER*
PETER BUSCEMI
JOHN F. STILLMUN, III

MORGAN, LEWIS & BOCKIUS
2000 One Logan Square
Philadelphia, PA 19103
(215) 963-5367

CHRISTINE A. HANSEN
RICHARD S. CHRISTNER
LARRY R. CRAYNE
DUQUESNE LIGHT COMPANY
1 Oxford Centre
301 Grant Street
Pittsburgh, PA 15279

JAMES R. EDGERLY
STEPHEN L. FELD
PENNSYLVANIA POWER COMPANY
1 East Washington Street
New Castle, PA 16103-0891

Attorneys for Duquesne Light Company and Pennsylvania Power Company

August 12, 1988

*Counsel of Record

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In this Reply Brief, the briefs of Appellees and supporting amici will be abbreviated as follows:

1. Brief for Appellee David M. Barasch, Consumer Advocate ("Brief for Consumer Advocate");

2. Brief for Appellee Pennsylvania Public Utility Commission ("Brief for PUC");

3. Brief for Consumer Federation of America, et al. ("Brief for CFA, et al.");

4. Brief of Industrial Energy Consumers of Pennsylvania, et al. ("Brief for IECPA");

5. Brief for the National Association of Regulatory Utility Commissioners ("Brief for NARUC");

6. Brief for the National Association of State Utility Consumer Advocates ("Brief for NASUCA");

7. Brief of the National Governors' Association, et al. ("Brief for National Governors' Assoc.").

No. 87-1160

In The Supreme Court of the United States

OCTOBER TERM, 1987

DUQUESNE LIGHT COMPANY
AND
PENNSYLVANIA POWER COMPANY
Appellants,

v.

DAVID M. BARASCH,
CONSUMER ADVOCATE, et al.
Appellees.

On Appeal from the Supreme Court of Pennsylvania

REPLY BRIEF FOR APPELLANTS

The briefs filed by Appellees and supporting amici obscure the critical way in which this case differs from prior utility rate cases in this Court. The controversy in those cases concerned such questions as how to measure the value of a utility's rate base, what items should be included in or excluded from the rate base, and how to calculate the return that a utility is entitled to earn on its rate base. In short, the cases to date have largely dealt with determining the constitutionally minimum return *on* a utility's investment that must be earned to compensate the utility's investors for the use of their investment dedicated to public use.

This case is different. Pennsylvania has told two of its utilities that they are not only barred from earning a

profit *on* their investment, but that they are also barred from recovering any of the out-of-pocket investment itself, an investment that, according to the PUC's own uncontested finding, was prudently incurred in fulfillment of the utility's statutory duty to provide electric service.

At all times relevant to this lawsuit, Duquesne and Penn Power operated under a statutory obligation to provide a reliable supply of electricity to their customers. That is not disputed. It is also not disputed that the utilities acted at all times in a perfectly reasonable and prudent manner in carrying out this obligation. They were prudent in deciding to add additional electric generating capacity. They were prudent in deciding that the capacity should be nuclear, since at the time nuclear power was projected as the least expensive alternative available to meet the burgeoning demand for electricity. They were prudent in cancelling the units when the demand for electricity unforeseeably collapsed. After encouraging the utilities to build additional capacity, and after the utilities had invested with the reasonable expectation that they would recover, at least, their prudent investment, Pennsylvania changed the rules to deny them any compensation, solely because their investment, when viewed with the benefit of perfect hindsight, was not deemed to be a success. This "end result," which requires the utilities to forfeit $50 million of money actually spent, is unfair and confiscatory.[1]

[1]The difference between the $50 million figure used by Appellants and the $44 million figure used by Appellees is a function of whether the Penn Power costs are stated in before-tax or after-tax dollars. Appellants have used the before-tax figure of $15,609,628, *see* Brief for Appellants at 7, n.9, and Appellees have used the after-tax figure of $9,569,665. *See* Brief for Consumer Advocate at 4. Both sides have used the Duquesne before-tax figure of $34,697,389.

Duquesne and Penn Power are constitutionally entitled to be "made whole," *FPC v. Hope Natural Gas Co.*, 320 U.S. 592, 606 (1944), for their prudent investment dedicated to public use. When a state places its utilities under a statutory obligation to serve, and the utilities prudently spend money for facilities intended to provide such service, under a regulatory scheme in which recovery of prudently incurred expenses is the rule, the utilities are at least entitled to get their money back.

This standard does not seek to render the utilities' investments "risk free." *See* Brief for PUC at 41-45; Brief for NARUC at 19; Brief for CFA, et al., at 63; Brief for IECPA, et al., at 17. As of today, the utilities have spent $50 million and have received nothing—no return *of* or *on* their money. Even if the utilities were today to receive $50 million, they would have earned no profit on their investment, and they would have lost the time value of their money. If the utilities prevail on this appeal and recover their $50 million through amortization over the next ten years, the real economic loss in terms of the time value of money will be even greater. Appellants' position in fact entails considerable risk even for undisputedly prudent investments, to say nothing of the even *greater* risk utilities must bear that their investments may be found to be imprudent or not properly directed toward fulfillment of the statutory obligation to provide electric service. It is simply false, therefore, to contend that Appellants' position would eliminate all investment risk.

Notwithstanding Pennsylvania's complete denial of any recovery of Appellants' $50 million investment, Appellees and supporting amici contend that Appellants somehow do not meet an alleged "threshold" test for constitutionally cognizable injury. Brief for Consumer

Advocate at 10. *See also* Brief for PUC at 34-36; Brief for National Governors' Assoc., et al., at 15-16; Brief for NARUC at 21-22; Brief for IECPA, et al., at 20. Simply put, Appellees argue that, because Appellants are substantial corporations, a deprivation of $50 million really does not matter enough to raise any constitutional concern. This argument has no merit. The alleged "threshold" test is arbitrary and unsupported. It would unjustifiably make findings of constitutional violations turn on the size of the victim.

Appellees also attempt to deny that the decision of the Pennsylvania Supreme Court is the least bit unusual or unexpected in the context of the State's regulation of utility rates. Relying on the so-called "used and useful" standard, Appellees maintain that rate orders denying any recovery of prudent investment are commonplace in the regulatory scheme. Brief for Consumer Advocate at 19-26; Brief for PUC at 23-27; Brief for National Governors' Assoc., et al., at 12-24; Brief for NASUCA at 12-27; Brief for IECPA, et al., at 19-25. This argument also has no merit. As historically used in utility rate regulation, and indeed as Appellee PUC argued below,[2] the "used and useful" standard has concerned what items should and should not be included in a utility's rate base and thus what return a utility should be permitted to earn *on* its investment. Contrary to appellees' assertion, the "used and useful" test has not ordinarily been used to limit utilities' recovery *of* prudently incurred expenses.

In the paragraphs that follow, each of these points is addressed in greater detail.

[2] *See* notes 6 & 11 *infra*.

1. This Court's decision in *Hope* does not preclude effective judicial review of Act 335 and the rate orders at issue. Appellees and supporting amici have seized upon *Hope*'s references to the "total effect" of a rate order as justification for their proposed "threshold" test. Appellees also appear to rely on *Hope* as authority for a kind of *per se* rule precluding all challenges to ratemaking methodologies, no matter how unfair, illogical, or manipulative, and focusing exclusively on the ratemaking authority's "end result." *See* Brief for Consumer Advocate at 14-19. Neither of these approaches makes any sense, and neither is supported by *Hope*, *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), or other decisions of this Court.

a. The proposed "threshold" test. The "threshold" test that Appellees and supporting amici read into *Hope* allegedly requires that, before any constitutional attack can be levelled, a rate order must have a financial impact that can be called "confiscatory." Significantly, however, there is no attempt to suggest a working definition of what "impact" would be sufficient to satisfy this test. Appellees' approach of comparing the amount of the investment at issue with the totality of the utilities' investment misses the mark. The "total effect" of the Pennsylvania Supreme Court's decision is that the investors of Duquesne and Penn Power once had $50 million and will never see that money again.

In *Hope*, the Court found that rates were not confiscatory because the rate order at issue permitted the utility to obtain a return *of*, and to earn a fair return *on*, its prudent investment, not because of the absence of some unspecified financial impact. The financial impact of a rate order on a utility is one of the "pertinent factors,"

Permian, 390 U.S. at 372, to be considered in balancing investor and consumer interests, and may sometimes be dispositive in demonstrating the unfairness of a particular rate order. However, financial impact in and of itself is not a determinative "threshold" for standing to advance a Fifth Amendment claim of confiscatory rates, particularly where the utility's return *of* its investment is at issue.

Applying such a threshold standard, moreover, is inherently arbitrary. For example, assuming that Duquesne is a large utility and Penn Power is small, or assuming Penn Power is in sound financial health and Duquesne is on the brink of bankruptcy, a rate order that treats the utilities in exactly the same manner might pass a "threshold" test of financial impact as to one utility and not the other. It would be an unjust rule of law in the context of the Fifth Amendment that sanctions a taking from large or financially sound utilities, yet compensates small or financially poor ones.

b. The alleged immunization of ratemaking methodologies. *Hope*'s reference to the "end result" of utility rate orders (320 U.S. at 603) does not, and was never intended to, bar this Court from scrutinizing, and in appropriate circumstances invalidating, particular ratemaking methodologies. In *Hope*, this Court was faced with the contention that the Fifth Amendment limited Congress to regulating natural gas rates according to a single method, the fair value approach of *Smyth v. Ames*, 169 U.S. 466 (1898). The Court held that the Federal Power Commission's use of the prudent investment method was contemplated by Congress and permissible under the Fifth Amendment. References in *Hope* and its

progeny[3] to the principle that only the "end result" may be considered in analyzing claims of confiscation must be recognized for what they are: a shorthand for the ultimate conclusion that there is no single ratemaking methodology, procedural or substantive, that the Fifth Amendment imposes on ratemakers. Such language was never intended to insulate all ratemaking methodologies, no matter how arbitrary, unfair, or irrational, from constitutional challenge.

Surely if the PUC set rates by selecting figures from a random number table or by having a monkey throw darts against a chart of numbers on a wall, those methods would not be sustained solely because the number selected was a permissible "end result." A broken clock is guaranteed to be right twice a day, but that does not make it an acceptable device for telling time.

Where a state applies inconsistent ratemaking standards that combine inevitably to prevent a utility from recovering its cost of doing business—as Pennsylvania has done in this case—that method is confiscatory. *West Ohio Gas Co. v. Public Utilities Comm'n*, 294 U.S. 63 (1935) (the mixing of distinct methods to guarantee a shortfall is *per se* unconstitutional). *See also Farmers Union Central Exchange Inc. v. FERC*, 734 F.2d 1486, 1527 (D.C. Cir.), *cert. denied*, 469 U.S. 1034 (1984) (combination of inconsistent ratemaking methodologies does not produce an acceptable "end result"); *American Telephone & Telegraph Co. v. FCC*, 836 F.2d 1386, 1390 (D.C. Cir. 1988) (same).

[3] *See, e.g., FCC v. Florida Power Corp.*, 480 U.S. 245 (1987), *FERC v. Pennzoil Producing Co.*, 439 U.S. 508, 519 (1979); *FPC v. Conway Corp.*, 426 U.S. 271, 278 (1976); *FPC v. Texaco, Inc.*, 417 U.S. 380, 391-92 (1974); *Mobil Oil Corp. v. FPC*, 417 U.S. 283, 316 (1974); *Montana-Dakota Utilities Co. v. Northwestern Public Service Co.*, 341 U.S. 246, 251 (1951); *Market Street Railway Co. v. Railroad Comm'n*, 324 U.S. 548 (1945).

Pennsylvania's methodology is unacceptable because it requires the PUC to shift between prudent investment and market value regulatory methods as needed to produce the lowest possible rate. If utility operations have successfully matched available electrical generating capacity and actual consumer demand for electricity, whether due to beneficial circumstances or to efficient utility management, Pennsylvania applies the prudent investment methodology. Under this approach, investors in the utility are restricted to a return *of* and a modest return *on* the historical value of their original investment. On the other hand, if utility management prudently expends funds to prepare for reasonably anticipated future growth, but that growth does not materialize, Act 335 is applied. Suddenly, the State looks not to the amount of the original prudent investment but rather to the market value of the items or services purchased. Regardless of how prudent an investment may have been when made, it is conclusively presumed to have no value and on that basis the statute bars the utility from retrieving any part of its investment.

Pennsylvania's ratemaking methodology divorces the standard for recovery from the decisions that govern the utility's expenditures. Because not even the most prudent manager possesses perfect foresight, Pennsylvania's mixing of ratemaking formulas guarantees that the utility will inevitably suffer losses that it cannot avoid.[4] Given the statutory duty to serve, a utility can-

[4]In the long run, this mixing of formulas necessarily will consume much of the capital invested in the business, as the inevitable losses from unforseeable detrimental conditions will not be restored by the gains from unforseeable beneficial conditions or from efficient utility management. This unrecovered long term consumption of investment is unfair and confiscatory. *See AT & T*, 836 F.2d at 1390-91.

not choose to avoid taking steps to expand its generating capacity in the face of consensus projections of higher electricity demand. Yet if that expansion turns out in retrospect not to have been needed because of changes in conditions that no one could have foreseen, the utility is penalized for doing something it had no choice but to do. A method that produces this "end result" is inherently unfair and confiscatory.

2. The "used and useful" standard does not bar recovery of prudently incurred expenses. Appellees and supporting amici argue that Pennsylvania's established application of the "used and useful" standard precludes recovery of the disputed costs and thus negates the reasonableness of any expectation that Appellants would recover their prudent out-of-pocket expenses even if the CAPCO units were not completed. Brief for Consumer Advocate at 19-26; Brief for PUC at 21-23; Brief for NASUCA at 12-27; Brief for CFA, et al., at 41-46. Appellees have erroneously sought to borrow a concept developed in another regulatory context and apply it here.

Historically, the "used and useful" standard has been employed as a limitation on the items that can properly be included in a utility's rate base. The standard has been applied, in other words, to limit the investment *on* which a utility could expect to earn a return. Before the Pennsylvania Supreme Court's interpretation of Act 335, the "used and useful" test was not applied to deny utilities a recovery *of* their prudently incurred expenses. Rather, Pennsylvania permitted its utilities to amortize their out-of-pocket costs for facilities that were rendered not "used and useful" by unforeseeable circumstances. *See, e.g., Pennsylvania Public Utility Comm'n v. Philadelphia Electric Co.*, 46 Pa. P.U.C. 746, 750 (1973) (10-year amortization of unusual expenses caused by tropical storm); *Pennsylvania Public Utility Comm'n v. UGI Corp.*-

Luzerne Electric Div., 47 Pa. P.U.C. 611, 634-35 (1974) (same); *Howes v. Mather Water Co.*, 13 P.U.R. 3d 486, 490 (1956) (14-year amortization of losses due to abandonment of contaminated water supply).[5]

For confirmation of this point, the Court need look no further than the PUC itself. The PUC's brief before the Pennsylvania Supreme Court in this very case removes all question about what the "used and useful" standard has meant in Pennsylvania and what Appellants understood it to mean when they prudently invested $50 million. In addressing the arguments of the Consumer Advocate and others that allowing recovery *of* the utilities' investment in the four CAPCO units would violate the "used and useful" standard, the PUC stated:

> What these parties purposefully overlook, however, is the fact that the used and useful standard controls the circumstances under which utility plant may be included in the rate base and thus earn a return *on* the investment in that utility plant. But even where investors are denied a return (earnings) on their investment in non-used and useful plant, the used and useful standard does not go so far as to sanction a taking of the investment itself.

[5]The *Philadelphia Electric* and *UGI-Luzerne* cases are particularly significant because they were decided contemporaneously with the decisions to begin the four CAPCO units. In June, 1972 an unforeseeable natural disaster known as Tropical Storm Agnes ravaged much of Eastern Pennsylvania. The PUC consistently allowed Pennsylvania utilities to amortize over 10 years their extraordinary losses caused by Tropical Storm Agnes. *See Pennsylvania Public Utility Comm'n v. Pennsylvania Gas & Water Co.*, 52 Pa. P.U.C. 525, 548-49 (1978); *Pennsylvania Public Utility Comm'n v. Philadelphia Electric Co.*, 48 Pa. P.U.C. 183, 202 (1974); *Pennsylvania Public Utility Comm'n v. Pennsylvania Gas & Water Co.*, 47 Pa. P.U.C. 750, 792 (1974); *Pennsylvania Public Utility Comm'n v. White Deer Mountain Water Co.*, 47 Pa. P.U.C. 530, 552 (1974); *Pennsylvania Public Utility Comm'n v. Bell Telephone Co. of Pennsylvania*, Pa. P.U.C. 247, 279-80 (1973).

Brief of Pennsylvania Public Utility Commission in the Supreme Court of Pennsylvania, p. 27 (hereinafter "PUC Pennsylvania Brief") (emphasis in original).[6]

The PUC goes on in its Pennsylvania Brief to cite an entire line of cases that applied the "used and useful" standard to deny a return *on*, but not *of* a utility's investment. PUC Pennsylvania Brief at 28-31. *See Philadelphia Electric Co. v. Pennsylvania Public Utility Comm'n*, 61 Pa. Cmwlth 325, 433 A.2d 620 (1981) (excluding from rate base a portion of a utility's generating plant that was excess capacity, but allowing recovery of operating expenses, including depreciation charges on the entire plant); *Pennsylvania Electric Co. v. Pennsylvania Public Utility Comm'n*, 509 Pa. 324, 502 A.2d 130 (1985), *appeal dismissed*, 476 U.S. 1137 (1986) (removing entire idle Three Mile Island (TMI) Unit No. 1 from rate base but permitting utility to recover its operating expenses related to the plant); *Pennsylvania Public Utility Comm'n v. Metropolitan Edison Co.*, 55 Pa. P.U.C. 428 (1982) (permitting amortization of costs associated with the damaged TMI Unit No. 2); *UGI Corp. v. Pennsylvania*

[6]This Court should generally disregard the positions taken by the PUC in its Brief in this Court. The PUC Pennsylvania Brief not only conceded, but argued, that Pennsylvania has historically differentiated between rate base (return *on*) and expenses (return *of*) in applying the "used and useful" test. PUC Pennsylvania Brief at 27-31. Further, the PUC argued that Act 335 is unconstitutional as applied to Appellants:

> [I]t would constitute an unconstitutional taking of public utility property (Duquesne's and Penn Power's share of the investment in the cancelled plants) to impose a public duty to commit the funds for a public purpose and then, after circumstances have changed causing the construction project to be cancelled, to deny Duquesne and Penn Power recovery of the funds prudently expended pursuant to its [sic] public duty.

Id. at 23. Perhaps as a result, the PUC's brief in this Court is confined exclusively to the issue of the constitutional right of utility investors to a return *on* their investment, an issue not directly presented on this record. Even in this Court, the PUC does not go so far as to suggest that the "used and useful" test has heretofore been applied in Pennsylvania to deny a return *of* a utility's investment.

Public Utility Comm'n, 49 Pa. Cmwlth. 69, 410 A.2d 923 (1980) (permitting amortization of terminated feasibility studies).

As the *Pennsylvania Electric* and *Metropolitan Edison* decisions show, Pennsylvania has permitted the utility owners of the Three Mile Island units, which of course were rendered not "used and useful" by the most serious nuclear incident in this country's history, to recover their out-of-pocket costs through amortization. The State, however, has retroactively and without warning refused to permit the same recovery to two utilities (and because of the bizarre interaction with the subsequently enacted 66 Pa.C.S. § 520, only these two utilities) that prudently cancelled their investments due to unforeseen and unforeseeable circumstances.

As a result of Pennsylvania's established regulatory scheme, Appellants reasonably expected that they would receive, at minimum, a recovery *of* their investment, even if unforeseeable circumstances rendered their investment not "used and useful." The concession by Appellees that the decision to commence work on the CAPCO units was prudent strongly confirms this conclusion, because it would have been wildly imprudent for Duquesne and Penn Power to embark upon the construction of four massive nuclear generating units without an expectation that they would *at least* ultimately see the return *of* the funds expended. By changing the rules of the game long after the investment in the four CAPCO units had been made, Act 335 has prevented Appellants from ever being compensated. This type of regulatory treatment is unfair and confiscatory.

3. A public utility is subject to a statutory duty to serve and is entitled to a return of prudent investments made in the performance of that duty. Appellees and supporting amici seek to apply to public utilities the

same legal standard for a "taking" that is applied to the regulation of non-utility businesses. Brief for Consumer Advocate at 34-39; Brief for National Governors' Assoc., et al., at 24-30; Brief for CFA, et al., at 4-41. These arguments ignore the unique role played by public utilities and the special duties and obligations imposed on them. Like many states, Pennsylvania has imposed on public utilities a statutory duty to serve. The relevant statute, 66 Pa.C.S. § 1501, provides:

> Every public utility shall furnish and maintain adequate, efficient, safe, and reasonable service and facilities, and shall make all such repairs, changes, alterations, substitutions, extensions, and improvements in or to such service and facilities as shall be necessary or proper for the accommodation, convenience, and safety of its patrons, employees, and the public. Such service also shall be reasonably continuous and without unreasonable interruptions or delay.

As a result of their statutory obligation to provide "adequate" and "reasonably continuous" service, public utilities, unlike other businesses, are required to assist the State in ensuring a reliable supply of electric power. The utility becomes, in effect, the State's agent. Justice Brandeis recognized this fundamental concept in declaring that a public utility "is the substitute for the state in the performance of the public service; thus becoming a public servant." *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Comm'n.* 262 U.S. 276, 291 (Brandeis, J. concurring).

Whereas states have been permitted generally to regulate non-utility businesses so as to "adjust [t]he benefits and burdens of economic life," *Penn Central Transportation Co. v. New York City*, 438 U.S. 104, 124 (1978), states may not thrust utilities into the role of a public servant without some form of protection. *Cf. Id.* at 120 n. 21 & 121 n. 23. *Accord, id.* at 146 & n. 9 (Rehn-

quist, J. dissenting). Where a utility has acted prudently in investing in plant expansion for the benefit of its consumers, "[t]he compensation which the Constitution guarantees an opportunity to earn is the reasonable cost of conducting the business." *Southwestern Bell*, 262 U.S. at 291.

Pennsylvania's attempt to deny Appellants any recovery of their $50 million investment cannot be justified as a "sharing" of risks. Under the State's approach, the consumer who enjoys the benefits of the utility's statutory obligation to provide continuous electric service need not assume any of the risk for prudent investments in electric generating facilities that are subsequently determined not to be "needed." Whereas the prudent investment standard balances investor and consumer interests by preventing the investors from recovering a return *of* or *on* imprudent investments, the approach adopted by the Pennsylvania Supreme Court below arbitrarily assigns the *entire* risk of cancellation to the investors without compensating investors for that risk and without any finding of fault on the part of management. Act 335 thus is not a mechanism by which risks are "shared," but rather a manipulative mechanism for shifting risks in their entirety onto the investors.[7]

[7]Appellees and amici stress Judge Starr's criticism of the prudent investment standard as being pro-utility. Brief of Consumer Advocate at 44-45; Brief of IECPA, et al., at 15-17, 25; Brief of NARUC, at 18-19, 23. *See Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168, 1190 (D.C. Cir. 1987) (Starr, J. concurring). These parties fail to acknowledge, however, that Judge Starr equally criticized the "used and useful" standard as being pro-consumer, even in a factual context where that standard was being applied, as it has been historically, solely to limit rate base and not to restrict recovery of prudent out-of-pocket expenses. Even in that context, Judge Starr said "the 'used and useful' rule, taken alone, is skewed heavily in favor of ratepayers. It also lacks balance." *See* 810 F.2d at 1191. While Appellants do not embrace all of Judge Starr's analysis, Act 335 plainly would not survive the constitutional test suggested by his concurrence:

> Thus it is that a taking occurs not when an investment is made (even one under legal obligation), but when the balance between investor

(Footnote continued on following page)

4. Duquesne and Penn Power undertook the investments at issue under statutory obligation and at the encouragement of the PUC. Appellees and supporting amici suggest that Appellants' decisions to invest in the four CAPCO units were entirely voluntary. *See* Brief for Consumer Advocate at 5; Brief for PUC at 19-20; Brief for IECPA, et al., at 7-8; Brief for CFA, et al., at 46-50.[8] Appellants volunteered in the same way an army private "volunteers" for a task "suggested" by his superior officer. Although the PUC's *Investigation of the Need for Additional Electric Generating and Transmission Facilities*, 46 Pa, P.U.C. 23 (1972), did not result in an order compelling Duquesne and Penn Power to build more capacity, the PUC's opinion in that *Investigation* details almost a decade's worth of PUC arm-twisting aimed at getting the utilities in the state to invest in more electric generating capacity. No one can seriously dispute that even as late as August 29, 1973, the PUC still perceived a "present emergency" concerning which

(Footnote continued from previous page)

> and ratepayer interests—the very function of utility regulation—is struck unjustly. Although the agency has broad latitude in striking the balance, the Constitution nonetheless requires that the end result reflect a reasonable balancing of the interests of investors and ratepayers. As we have seen, both investors and ratepayers were the intended beneficiaries of the Forked River investment; both should presumptively have to share in the loss.

810 F.2d at 1191.

[8]CFA also asserts that Appellants voluntarily assumed the risks associated with nuclear power plants and the building of "excessive" generation because the "electric industry debate" about capital expansion "had already begun." Brief for CFA, et al., at 49. Whether the law review articles cited constitute an "industry debate" is questionable. Further, this Court has recently observed that "[a]t the time construction of [the Grand Gulf nuclear power plant] was initiated [in April 1974], no one anticipated the enormous cost overruns that would be associated not only with that plant but also with virtually every nuclear power facility being constructed in the United States." *Mississippi Power & Light Co. v. Mississippi*, 108 S.Ct. 2428, 2436, n.9 (1988).

the PUC "*insisted* that construction be accelerated. . . ." *Pennsylvania Public Utility Comm'n v. Metropolitan Edison Co.*, 47 Pa. P.U.C. 56, 59 (1973) (emphasis added). As the PUC itself acknowledged in the court below, the PUC's view was that Appellants had "the duty to plan and construct new power plants." PUC Pennsylvania Brief at 22-23. Given the utilities' statutory obligation to provide service, as well as the PUC's role in regulating their rates, the utilities would have been imprudent in the extreme if they had not responded to the urgings of the PUC.

5. State action, and not market forces, has prevented the utilities from recovering their investment. Appellees and supporting amici rely on *Market Street Railway Co. v. Railroad Comm'n*, 324 U.S. 548 (1948), for the proposition that a utility cannot constitutionally challenge a rate order where "market forces" have caused the taking. *See* Brief for Consumer Advocate at 23-24; Brief for PUC at 36-38; Brief for National Governors Assoc., et al., at 18,22; Brief for CFA, et al., at 40,46; Brief for NASUCA at 40-42; Brief for IECPA, et al., at 18. *Market Street Railway* is not applicable to this case. It is true that market forces, in the form of an unforeseeable failure of electric demand, triggered the prudent decision to cancel the four CAPCO units. But it is not market forces that are preventing Appellants from collecting the rates they seek here. The street railway in *Market Street Railway* was unable to earn sufficient revenue to cover its costs, not because the rate order prescribed rates that were too low, and not because it was denied a return *of* or *on* any of its prudent investment, but rather because the railway simply was unable to compete with other modes of transportation. It was unable to attract enough fare-paying riders to cover its expenses. The present case is unlike *Market Street Railway*. Appellees

and supporting amici concede that, although the amounts at issue are measured in the tens of millions of dollars, these amounts represent only a small fraction of the rates involved, and thus clearly could be absorbed by the market.[9] The utilities' inability to recover their expenses in this case is the result of the State's refusal to include these costs in rates and not competition or market forces.

6. The investors in Duquesne and Penn Power have not otherwise been compensated in rates. Appellees and supporting amici have argued that providing a return *of* investment results in double counting where a larger than normal return *on* the investment has been allowed in anticipation of adverse conditions. *See, e.g.*, Brief for CFA, et al., at 53.[10] That consideration cannot save Pennsylvania's method of fixing rates. Appellees and supporting amici themselves assert that the effect of Act 335 and other unspecified Pennsylvania ratemaking legislation is to prohibit recovery of prudent uncompleted plant expenses either in rate base or "otherwise . . . in the rates charged," thus precluding recovery as a surcharge added to the rate of return.

The rates of return fixed by the PUC in this case for Duquesne and Penn Power have been set on the as-

[9] *See* Brief for Consumer Advocate at 12; Brief for PUC at 35; Brief for IECPA, et al., at 20. Amici Consumer Federation of America, et al., argue that the test should be the ability of Appellants to recover their cancellation costs in a hypothetical free market, and that Appellants cannot meet that test because other competitors will not have unforeseeable prudent investment losses, and will therefore set the industry price level too low to permit Appellants to retrieve their cancellation costs. Brief for CFA, et al., at 52-53. In addition to its lack of record support, a hypothetical free market approach would complicate an already complex regulatory process with a layer of unnecessary economic speculation.

[10] *See e.g., Washington Gas Light Co. v. Baker*, 188 F.2d 11, 19-20 (D.C. Cir. 1950), *cert. denied*, 340 U.S. 952 (1951); *Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168 (D.C. Cir. 1987) (Mikva, J. dissenting).

sumption that the cancellation costs associated with the four CAPCO units would be recovered by amortization *of* those costs. The PUC, intimately familiar with its own past practices and mindful of its constitutional obligations,[11] necessarily recognized that there was no need to adjust the utilities' rates of return to compensate investors for the risk of losing their out-of-pocket investment due to unforeseeable circumstances, since it had ordered that the utilities be compensated directly through amortization. Act 335 denies the investors of Duquesne and Penn Power this just compensation.

The utilities cannot be expected to have received their compensation by operation of the market. If the risk is not foreseeable, the market will not include the risk in the utility's or the industry's price-earning ratios or other financial indicators, and the risk, therefore, will not be included in the utility's return on equity. Pennsylvania's method of ratemaking, moreover, guarantees that the utilities will not be compensated by higher returns in the future. Because investors will always be restricted to a modest return on the historical value of their original investment, a capital loss created by unforeseeable detrimental conditions will not be restored by the gains from unforeseeable beneficial conditions or from efficient utility management. In short, the utility is unable to use the profits from its "Mustangs" to restore the losses from its "Edsels." This unrecovered con-

[11] *See, e.g.*, note 5, *supra*, and accompanying text. The PUC not only conceded, but argued below that:

> [A]lthough the Commission may deny rate base recognition and thus a return *on* the investment in cancelled power plants, it would constitute a violation of the Fifth and Fourteenth Amendments to the United States Constitution to deny the electric utilities recovery *of* the costs prudently invested and incurred.

PUC Pennsylvania Brief at 22 (emphasis in original).

sumption of investment mandated by state action is inherently unfair and confiscatory.

7. The investment in the four CAPCO units was not a "failed" investment. The attempts of Appellees and supporting amici throughout their briefs to characterize the investments at issue as "failures" or "mistakes," and their assault upon the prudent investment test generally, are nothing more than an attempt to subvert the factual finding of prudence on this record. Nothing in the record supports any inference that the expenditures on the CAPCO units were "excessive", "wasteful" or motivated by anything other than the utilities' statutory duty to ensure a continuous supply of electricity. The prudently incurred costs involved in this case were "failed" costs (or costs carrying similar implications of misfortune, imprudence or lack of utility) only in the sense that fire insurance costs are "failed" costs because no fire occurred during the policy period. Appellants' ratepayers obtained the security of having sufficient electric energy potentially available to meet the then-consensus predictions of need. As a matter of "justness and fairness," *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 607, (1942) (Black, J. concurring). they should at least share in the associated costs.

CONCLUSION

For these reasons, as well as the reasons set forth in Appellants' opening brief, the judgment of the Supreme Court of Pennsylvania should be reversed and the rate orders of the PUC reinstated.

Respectfully submitted,

ALAN L. REED
WILLIAM E. ZEITER*
PETER BUSCEMI
JOHN F. STILLMUN, III

MORGAN, LEWIS & BOCKIUS
2000 One Logan Square
Philadelphia, PA 19103
(215) 963-5367

CHRISTINE A. HANSEN
RICHARD S. CHRISTNER
LARRY R. CRAYNE
DUQUESNE LIGHT COMPANY
1 Oxford Centre
301 Grant Street
Pittsburgh, PA 15279

JAMES R. EDGERLY
STEPHEN L. FELD
PENNSYLVANIA POWER COMPANY
1 East Washington Street
New Castle, PA 16103-0891

Attorneys for Duquesne Light Company and Pennsylvania Power Company

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*Counsel of Record

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Supreme Court of the United States

OCTOBER TERM, 1987

DUQUESNE LIGHT COMPANY

AND

PENNSYLVANIA POWER COMPANY,
Appellants,

v.

DAVID M. BARASCH,
CONSUMER ADVOCATE, *et al.*,
Appellees.

On Appeal from the Supreme Court of Pennsylvania

BRIEF OF EDISON ELECTRIC INSTITUTE AS *AMICUS CURIAE* IN SUPPORT OF APPELLANTS

ROBERT L. BAUM
Counsel of Record
PETER B. KELSEY
EDISON ELECTRIC INSTITUTE
1111 19th Street, N.W.
Washington, D.C. 20036
(202) 778-6500

May 5, 1988

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

QUESTIONS PRESENTED

The Edison Electric Institute adopts the questions presented set forth in the brief of appellants Duquesne Light Company and Pennsylvania Power Company.

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IN THE

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DUQUESNE LIGHT COMPANY

AND

PENNSYLVANIA POWER COMPANY,
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CONSUMER ADVOCATE, *et al.*,
Appellees.

On Appeal from the Supreme Court of Pennsylvania

BRIEF OF EDISON ELECTRIC INSTITUTE AS *AMICUS CURIAE* IN SUPPORT OF APPELLANTS

The Edison Electric Institute (EEI) hereby submits its brief *amicus curiae* in support of the appeal filed by Duquesne Light Company and Pennsylvania Power Company.[1]

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[1] EEI has obtained the written consents of all parties to this case. The written consents have been filed with the Clerk of this Court.

INTEREST OF *AMICUS CURIAE*

EEI is the national association of investor-owned electric utility companies in the United States. Its members supply electric service to consumers throughout the United States, serving approximately 97 percent of all customers of the investor-owned segment of the industry and 73 percent of the nation's electricity customers.

The Pennsylvania Supreme Court has held that the Pennsylvania Public Utility Code and particularly Act 335 (as incorporated in the Code as 66 Pa.C.S. § 1315) governing the determination of rates by the Pennsylvania Public Utility Commission (PUC) precludes any recovery through rates of costs of planning, engineering and preliminary procurement prudently incurred by Appellants in carrying out their obligation to provide necessary and adequate facilities, when the projects for which such costs were incurred were prudently canceled by reason of changed circumstances. As so construed by the Pennsylvania Supreme Court, the Pennsylvania statute resurrects the pre-20th century practice of direct legislative determination of utility rates by specific tariffs or specific formulae which ignore the constitutional constraints upon such governmental actions.[2]

In recent years, there have been many cancellations of electric generating plant construction projects in which, in the aggregate, billions of dollars had been invested by the date of cancellation. In the great majority of such cases, commissions and courts have allowed recovery *of*

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[2] *Smyth v. Ames*, 169 U.S. 466 (1898), upon which the Pennsylvania Court purports to base its decision in this case in large part, involved, for example, a Nebraska statute prescribing classifications of freight and rates for intrastate railroad transport. Similarly, *Covington & Lexington Turnpike Rd. Co. v. Sandford*, 164 U.S. 578 (1896), involved a Kentucky statute prohibiting a turnpike company from charging tolls in excess of the rates specified therein.

the prudent investments made in such canceled projects.[3] However, as here, state legislatures have more frequently enacted statutes which, as construed by the courts of those states, have limited the authority of public utility commissions to allow recovery of any portion of such costs, without consideration of the constitutional limitations upon the unbalanced results of such action.[4]

The fact that this Court has not heretofore fully addressed on the merits such state legislative and judicial actions has been viewed by some as a demonstration that "[t]he Constitution no longer provides any special protections for the utility investor," *Dayton Power & Light Co. v. Pub. Util. Comm'n*, 4 Ohio St.3d 91, 447 N.E.2d 733 (1983), and as providing *carte blanche* to state legislators to deny utility investors recovery of the prudent investment that the utilities previously made in response to their statutory obligations to serve and, as here, spe-

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[3] Such recovery of the investment in canceled projects is typically permitted by the allowance of charges for amortization of the prudent investment over a period of years without any return *on* the unamortized investment, although some jurisdictions (*e.g.*, New York and Wisconsin) have permitted both return of, and on, the prudent investment. After lengthy rulemaking proceedings, the Federal Energy Regulatory Commission recently issued an order authorizing amortization charges *of* one-half of the investment, but also authorizing return *on* that one-half of the investment. *New England Power Co.*, 42 FERC ¶ 61,016, *reh'g granted* (1988). The result is essentially equivalent to allowance of recovery *of* the entire investment without any return on the investment.

[4] *See, e.g.*, Ohio and Indiana, whose statutes were involved in appeals to this Court that were dismissed for want of a substantial federal question or properly presented federal question. *Office of Consumers' Counsel v. Pub. Util. Comm'n*, 67 Ohio St.2d 153, 423 N.E.2d 820 (1981), *appeal dismissed*, 455 U.S. 914 (1982); *Cleveland Elec. Illuminating Co. v. Pub. Util. Comm'n*, No. 82-165 (Ohio, July 7, 1982), *appeal dismissed*, 459 U.S. 1094 (1983); *Citizens Action Coalition of Indiana, Inc. v. Northern Indiana Pub. Serv. Co.*, 485 N.E.2d 610 (1985), *appeal dismissed and cert. denied*, —— U.S. ——, 106 S.Ct. 2239 (1986).

cific public utility commission directives. In the last term, this Court struck down an effort by a state agency to confiscate private property in the guise of conditioning a building permit. *Nollan v. California Coastal Comm'n*, —— U.S. ——, 107 S. Ct. 3141 (1987). This case demonstrates the nationwide need to similarly preclude direct confiscation of private property in the guise of public utility regulation.

This appeal represents a critical juncture both for the nation's investor-owned electric utilities and for the constitutional rules fashioned by this Court. For the Fourteenth Amendment to have meaning and continuing validity as a check on state ratemaking authority, the Court must remind state courts and regulators that the investor interest articulated by this Court in *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), is more than a hollow phrase.

As the national association of investor-owned electric utilities, EEI represents the interests of companies throughout the country whose future rate cases may well be affected by the decision in this case. This brief *amicus curiae* presents, from the perspective of those companies which have committed substantial investment in new generating facilities pursuant to state-mandated obligations to serve, the reasons why the "used and useful" test cannot be determinative under the Constitution and this Court's decision in *Hope*, of investors' rights to recover their prudent investment. This Court's decision will be highly significant to the privately-financed electric utility industry and the long-term costs to consumers served by it. In light of the recent trend in state court and commission decisions, as reflected in the decision below, it is essential that the balancing required under *Hope* include consideration of factors contributing to a continued supply of investment capital at reasonable costs.

SUMMARY OF ARGUMENT

The Pennsylvania Supreme Court has leapt backwards over intervening decisions of this Court to rely upon outmoded ratemaking concepts in order to sustain the constitutionality of a state law interpreted to preclude decisions of the Pennsylvania Public Utility Commission (PUC) that fairly balanced the interests of utility ratepayers and investors as required by *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). The court below seized upon the "used and useful" doctrine, having its origins in *Smyth v. Ames*, 169 U.S. 466 (1898), to overturn the result of the *Hope* balance struck by the PUC permitting Appellants a constitutionally required return *of* their investment in canceled generating plants. Yet, while not acknowledged by the lower court, this Court in *Hope* freed public utility commissions and state courts from the shackles of *Smyth v. Ames*, requiring commissions instead to reach an "end result" that reflects a balance between the interests of investors and ratepayers. The lower court's attempt to resurrect that ancient past, particularly where application of the earlier ratemaking doctrine reaches a result inconsistent with the requirements of *Hope*, must not go uncorrected.

In relying upon pre-*Hope* decisions of this Court to uphold the constitutionality of Act 335, the Pennsylvania Supreme Court failed to respond to the balancing required by *Hope* and struck by the PUC and to consider the factors pertinent to that balance. For example, construction of generating facilities was encouraged at the national level and insisted upon at the state level. Throughout the process of planning for and cancellation of the subject facilities, the prudent nature of the investments was undisputed. The costs of planning, engineering and preliminary procurement were initiated by the utilities in recognition of their obligation to provide their customers with continuous, reliable electric service. Not until almost three years after cancellation of the

projects by Appellants was Act 335 adopted by the Pennsylvania Legislature.

As a consequence of ignoring this Court's teachings in *Hope*, *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), and *Fed. Power Comm'n v. Memphis Light, Gas & Water Div.*, 411 U.S. 458 (1973), the Pennsylvania Supreme Court, unlike the Pennsylvania PUC, failed to reach an end result that reflects a balance between the interests of ratepayers and investors that is just and reasonable. Under the factors present in this case, the Pennsylvania Supreme Court decision striking down the PUC rate determination that allows recovery of prudently incurred investment fails to comply with the teachings of this Court and must be overturned.

ARGUMENT

I. THE PENNSYLVANIA STATUTE AS CONSTRUED BY THE PENNSYLVANIA SUPREME COURT REPRESENTS A RETURN TO RATEMAKING BY RIGID LEGISLATIVE FORMULA WHICH IGNORES THE TEACHINGS OF THIS COURT.

In the decision which is the subject of this appeal, the Pennsylvania Supreme Court purported to recognize that:

> the property of a public utility, though devoted to the public service and convenience, is still private property; and neither the corpus of that property nor the use thereof can be constitutionally taken for a compulsory price which falls below the measure of just compensation.

Barasch v. Pennsylvania Pub. Util. Comm'n, 516 Pa. 142, 532 A.2d 325, 335 (Pa. 1987).

In support of what it characterized as "[t]his deeply rooted principle of constitutional law," the Pennsylvania Supreme Court cited numerous decisions of this Court, commencing with *Railroad Commission Cases*, 116 U.S. 307 (1886), through *Fed. Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575 (1942). It is all the more striking that the Pennsylvania Court did not even cite—let alone attempt to distinguish—the decisions of this Court in *Fed. Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), and its progeny, such as *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), and *Fed. Power Comm'n v. Memphis Light, Gas & Water Div.*, 411 U.S. 458 (1973).

In so doing, the Pennsylvania Court ignored the developments of the past four and half decades in applying the principles of constitutional law to public utility ratemaking. Instead, the Pennsylvania Court largely parroted *dicta* from decisions of the pre-*Hope* era, without pausing to consider the consequences of its actions.

At this late date, constitutional analysis of public utility ratemaking that rests upon what the Pennsylvania Court characterized as "the landmark case of *Smyth v. Ames*, 169 U.S. 466 (1898)" may have interest for the historian (although its deficiencies are an oft-told tale), but it has little relevance to present-day governing judicial doctrines. Instead, while a legislature or its delegate (a public utility commission) has discretion to select whatever ratemaking methodology or formula that it chooses, the end result of its ratemaking and orders must balance the interests of consumers and investors in the manner delineated by this Court in *Hope*, namely: (1) "to protect consumers against exploitation," and (2) "to promote the 'financial integrity' of the [utility] as measured, not only by revenues sufficient to recover operating expenses and capital costs . . . but also by revenues sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[5]

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[5] This summary of the holding in *Hope* appears in the unanimous opinion of the Court in *Memphis*, 411 U.S. at 465-66.

The opinion of the Pennsylvania Supreme Court also lacks perspective about the role of government in causing the projects that are the subject of this appeal to be undertaken. Here, the "taking" that is the subject of this appeal had its origin in the encouragement at the national level, and insistence at the state level, upon the construction of additional prudent generating facilities. Moreover, at that time, national policy was for a variety of reasons strongly oriented toward nuclear generation.[6]

Before the subject projects were undertaken in 1973, President Eisenhower, each of his successors and the Congress had expressly and repeatedly encouraged the construction of nuclear power plants. At the state level, in the face of rapidly soaring demands for electricity, the PUC, as delegate of the Pennsylvania Legislature, instructed Appellants and other Pennsylvania electric utilities "to add additional generating facilities as rapidly as possible to meet adequately the public demand for service." *Pennsylvania Pub. Util. Comm'n v. Metropolitan Edison Co.*, 47 Pa. P.U.C. 56, 59 (1973). Appellants responded in part by undertaking the four units here involved.

As a result of subsequent unexpected, unforeseeable developments, these governmental initiatives and the actions taken by Appellants in response thereto proved to be unnecessary, and in January 1980 the four nuclear units were canceled. In all relevant proceedings before the PUC and the Pennsylvania courts, the prudent nature of the investments made in connection with these four units was undisputed. Almost three years after such cancellation by Appellants, the Pennsylvania Legislature adopted Act 335. Although the PUC and the Commonwealth Court had construed Act 335 as not precluding[7] the recovery in rates of the subject costs, the Pennsylvania Supreme Court held otherwise in the decision that is the subject of this appeal.

[6] *See, e.g.*, Atomic Energy Act, 42 U.S.C. §§ 2131-34, 2235 (1982); Powerplant and Industrial Fuel Use Act, 42 U.S.C. § 8311 (1982); 16 U.S.C. § 824a(g) (1982); *see also* Federal Power Commission, *The 1970 National Power Survey*, Part I at I-6-1, I-6-5 (1971).

Accepting, as one must, that construction of the Pennsylvania legislation by the highest court of that state, the issue then posed is whether the Pennsylvania Supreme Court is correct in its assertion that the just compensation safeguarded to a utility by the Fourteenth Amendment does not include any return on, or of, property that is not "used and useful" in the public service. As previously noted, the Pennsylvania Court purports to rest that assertion on the pre-*Hope* "fair value" decisions of this Court and did not address the question of whether the end result of its decision would satisfy the *Hope* and *Permian* standards.

The Pennsylvania Court's decision starts with its purported acknowledgment that the Fourteenth Amendment is a constraint on the ratemaking actions of a state legislature and public utility commission. (Although not addressed by the Pennsylvania court, that constraint is applicable to a state court as well.) The Pennsylvania Supreme Court's decision then proceeds with an analysis of the pre-*Hope* decisions of this Court as if they continued to provide an authoritative statement of governing law.

The whole of the discussion by the Pennsylvania Supreme Court of the pre-*Hope* decisions of this Court assumes a unity of principle and application in those decisions that is contrary to fact. During the pre-*Hope* period, commissions and courts (principally the federal

[7] In a concurring opinion, the President Judge of the Commonwealth Court stated, "Serious constitutional problems would be raised by precluding a utility from ever regaining monies prudently invested for the public's benefit." *Cohen v. Pennsylvania Pub. Util. Comm'n*, 90 Pa. Commw. Ct. 98, 494 A.2d 58, 64 (Pa. 1985).

district courts until the enactment of the Johnson Act [8]) struggled to apply a hodgepodge of concepts to regulation of the rates of railroads and other utilities. Valuations of utilities on the basis of fair value, going-concern value and the like proved to be well-nigh unworkable, as did the attempts by this Court to provide formulae or methodologies capable of universal application. Although Justice Brandeis was particularly articulate and comprehensive in his criticism of what had come to pass,[9] he was far from alone. The insistence of the Pennsylvania Supreme Court on attempting to resurrect that discarded past is unfortunate.[10]

The criteria of *Hope* and its progeny, when applied to adequate findings of fact and conclusions of law,[11] make good sense and are susceptible to consistent application. By contrast, it does not make good sense for government

[8] 28 U.S.C. § 1342 (1982).

[9] *See, e.g., Missouri ex rel. Southwestern Bell Tel. Co. v. Pub. Serv. Comm'n*, 262 U.S. 276, 289-312 (1923) (Brandeis, J., concurring).

[10] It is noteworthy that the Pennsylvania Supreme Court focused on what it conceived to be a constitutional requirement limited to property that is "used and useful" for public utility purposes and wholly ignored the rate base, "fair value" criterion that was a part of the pre-*Hope* era decisions. This is a curiously "unbalanced" reading of those decisions.

[11] In *Permian*, the Court emphasized the necessity for adequate findings, stating:

> Judicial review of the Commission's orders will therefore function accurately and efficaciously only if the Commission indicates fully and carefully the methods by which, and the purposes for which, it has chosen to act, as well as its assessment of the consequences of its orders for the character and future development of the industry.

390 U.S. at 792. In this case, the PUC had met that requirement. However, the Pennsylvania Court ignored completely the necessity to do so. The admonitions of this Court in this regard are equally applicable to intermediate appellate courts. *See Memphis*, 411 U.S. at 474.

at one time to insist that investment be made in new facilities requiring long construction periods and then a few years later to reject recovery *of* that investment (let alone return *on* that investment). It makes even less sense for the judiciary to impose that result, as the Pennsylvania Court did in this case.

II. THE DECISION OF THE PENNSYLVANIA SUPREME COURT IMPOSES A FUNDAMENTALLY UNBALANCED RATEMAKING STANDARD.

The "used and useful" [12] concept for determining the composition of rate base is generally viewed (as indeed the Pennsylvania Supreme Court appeared to do) as attributable to the following statement in *Smyth v. Ames*:

> We hold however that the basis of all calculations as to the reasonableness of rates to be charged by a corporation maintaining a highway under legislative sanction must be the *fair value of the property being used by it for the convenience of the public*. And in order to ascertain that value, the original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds and stock, the present as compared with the original cost of construction, the probable earning capacity of the property under particular rates prescribed by statute and the sum required to meet operating expenses, are all matters for consideration, and are to be given such weight as may be just and right in each case. We do not say that there may not be other matters to be regarded in estimating the value of the property. What the company is entitled to ask is a fair return *upon the value of that which it employs for the public convenience.*

169 U.S. at 546-47 (emphasis added).

[12] As noted below, the *Smyth v. Ames* Court did not employ the term "used and useful," but somewhere along the way that apparently catchy phrase was substituted for the actual phrase employed by the Court. Like most catch phrases, the "used and useful" phrase is less than correct in this situation.

The Court did not in *Smyth* identify the test for determining what "property [was] being used by [the corporation] for the convenience of the public," and indeed, that issue was not presented in *Smyth* or in most of the cases of the pre-*Hope* era cited by the Pennsylvania Supreme Court in which the "used and useful" phrase was glibly employed.[13] Moreover, although the Court in *Smyth* held that the rates prescribed by the Nebraska Legislature were unlawful because they would have deprived the railroads of "the just compensation secured to them by the Constitution," 169 U.S. at 547, the Court did not provide a rationale for limiting rate base to "property being used by [them] for the convenience of the public."

Subsequently, a rationale was supplied by commentators and lower courts, namely, that the utility was entitled to just compensation only for property that was "taken" for the public service and that it could not expect just compensation (*i.e.*, a return) on the investments in property which would not be "taken" because it was not "used and useful."[14] Later, when reproduction cost became the favored method for determining rate base, the rationale for limiting rate base to "used and useful" property was that it would be unreasonable to include in rate base (and burden consumers with the reproduction cost of) property which no one would think

[13] *See, e.g., Bd. of Pub. Util. Comm'rs v. New York Tel. Co.*, 271 U.S. 23 (1926), and *McCardle v. Indianapolis Water Co.*, 272 U.S. 400 (1926), both cited by the Pennsylvania Supreme Court as supporting its view, where there was no issue in this Court's discussions of excluding property as not used or useful.

[14] *See Washington Gas Light Co. v. Baker*, 188 F.2d 11, 18 (D.C. Cir. 1950), *cert. denied*, 340 U.S. 952 (1951), commenting on that rationale and explaining that, with the demise of "fair value," the "used and useful" concept ceased to have any constitutional significance and is now simply one of several permissible tools of ratemaking and one that need not be, and is not, employed in every instance.

of reproducing.[15] *See Washington Gas Light Co. v. Baker*, *supra* n.14.

Thus, with the decision in *Hope*, the necessity to invoke the "used and useful" doctrine disappeared along with the disappearance of the necessity to employ the "fair value" ratemaking methodology required by *Smyth v. Ames*. The *Hope* criteria for ascertaining whether the rates prescribed are "just and reasonable" have no necessary, or even rational, nexus to a rate base determined on the basis of "used and useful" property, as distinguished from prudent investment. Ratemaking was freed from the shackles of *Smyth v. Ames* because, as evidenced by the instant proceeding, the "used and useful" test is not necessarily consistent with the *Hope* criteria.

In light of *Hope* and its progeny, reviewing courts should put permanently to rest the impression that rate regulatory bodies are required to employ the "used and useful" principle as a matter of law, for at least three reasons:

1. The "used and useful" principle is being increasingly invoked to justify a breach of the implicit and fundamental bargain between investors in the securities of electric utilities and the utilities' customers (sometimes referred to by judges and commentators as the "regulatory compact"). It is resulting in the expropriation of millions of dollars of investment with no excuse

[15] In *Los Angeles Gas & Electric Corp. v. R.R. Comm'n*, 289 U.S. 287 (1933)—one of the last cases in which *Smyth v. Ames* was attempted to be applied—the vagaries of such treatment and their rationale were illustrated when the Court upheld a rate order that included in the $60.7 million historical-cost measure of value the $10 million investment in a manufactured gas facility that was being rendered unnecessary by reason of the introduction of natural gas, but excluded such facility from the higher, reproduction-cost measure of value, both of which measures of value were factored into the development of a fair value rate base.

other than the glib "used and useful" phrase.[16] Assuming that rationality will prevail among investors in the long run—whose investment decisions will reflect the increased risk caused by unconstitutional takings—one can anticipate that at minimum the cost of electric power will be increased and, if the trend is carried to its logical extreme, the availability of electricity will be reduced as a consequence of such expropriation.

2. Because the inappropriateness of the "used and useful" principle has not been dealt with forthrightly, it has become a rallying cry for those opposed to current rate increases, no matter how well justified such current increases are, and even for legislation enacted in several states. Moreover, the opinion of the Pennsylvania Supreme Court in this case can only be read as holding that the "used and useful" principle with its *Smyth v. Ames* parentage takes precedence over the balancing requirements of *Hope* and *Memphis*.

3. The "used and useful" principle is inherently asymmetrical and unfair when employed to exclude recovery of prudent investment in assets that are not "used and useful," in conjunction with limiting recovery to prudent investment, rather than current market value, for those assets that are conceded to be "used and useful."

Since *Hope* there has not been a decision of this Court employing the "used and useful" concept as a limitation on utility rates. Moreover, even in those pre-*Hope* decisions of this Court that are cited by the Pennsylvania Supreme Court as a basis for its decision in this case to exclude recovery in rates of the subject prudent in-

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[16] *See Permian*, 390 U.S. at 791 n.60: "The Commission's exercise of its regulatory authority must be assessed in light of its purposes and consequences, and not by references to isolated phrases from previous cases," and *id.* at 775: "[T]his Court does not decide important questions of law by cursory *dicta* inserted in unrelated cases."

vestment, a careful examination discloses that the investments actually so excluded by this Court in those cases were in property that was not, and had never been intended for, use in the utility or regulated business.

Specifically, *Denver Union Stock Yard Co. v. United States*, 304 U.S. 470, 475 (1938), involved a statute authorizing the Secretary of Agriculture to regulate rates for the furnishing of stockyard services. In exercising that authority the Secretary employed a rate base/rate of return methodology. Certain property was excluded by the Secretary from rate base because it was not, and had never been, property "used and useful" for the performance of the stockyard services covered by the regulated rates; *i.e., the excluded property was wholly outside the scope of the statute because it involved an unregulated business.* This was also the situation in *St. Joseph Stock Yards Co. v. United States*, 298 U.S. 38, 56-57 (1936). And in *United Gas Pub. Serv. Co. v. Texas*, 303 U.S. 123, 136, 144 (1938), although the commission and court below questioned the inclusion in rate base of some properties on the ground that they were not used or necessary as standby equipment, such properties were, in fact, included in rate base, albeit at modestly reduced valuations. Finally, in *Natural Gas Pipeline*, 315 U.S. at 590, the statement made about "used and useful" was of a general nature and not reflective of an issue presented in that case.

In the pre-*Hope* period, it may have been conceptually possible to reconcile the exclusion nature of the "used and useful" concept with a "fair value" rate base—*i.e.*, a consistent, after-the-fact basis of valuation was being employed.[17] But, with *Hope*, which is now almost universally implemented in practice (regardless of the

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[17] *See, e.g., McCardle*, 272 U.S. at 410: "It is well established that values of utility properties fluctuate, and that owners must bear the decline and are entitled to the increase."

phrasing of the valuation basis) by a prudent investment before-the-fact basis of valuation, it is asymmetrical and incongruous to apply an after-the-fact basis of valuation only to certain components of that total valuation—*i.e.*, to say that the investor may have included in rate base only the lower of cost or current market value (if any) of each asset, treated separately, and therefore, that the investors must bear the entire loss *of*, as well as *on*, prudent investments in projects which are prudently canceled by reason of changed circumstances.

The three opinions of the *en banc* United States Court of Appeals for the District of Columbia Circuit in *Jersey Central Power & Light Co. v. Fed. Energy Reg. Comm'n*, 810 F.2d 1168 (D.C. Cir. 1987), are illuminating on this score. In the *Jersey Central* case, there was a sharp disagreement among the views expressed by (1) Judge Bork for the majority, (2) Judge Starr in concurrence, and (3) Judge Mikva on behalf of the dissenters. That disagreement centered upon whether the "used and useful" concept precluded a utility from receiving a return *on* its unamortized investment in abandoned utility projects. But all three opinions were unanimous in assuming or holding that the "used and useful" concept does not constitutionally preclude recovery *of* the utility's total prudent investment in a project intended for utility purposes which is canceled. Thus, all three opinions in *Jersey Central* support the view that the Pennsylvania Court was wrong in its assertion in this case that the recovery *of* the subject investment is constitutionally barred by the "used and useful" concept. In fact, the PUC decisions, unencumbered by the "used and useful" doctrine, properly balanced the interests of investors and consumers, and was correct. Recovery of prudent investment in this case is fair, logical and constitutionally required.

CONCLUSION

This Court should make clear that the Pennsylvania Supreme Court erred in applying the Pennsylvania statutes to bar the recovery of prudent investment in costs for plants that because of unforeseeable circumstances were subsequently canceled. Moreover, this Court should recognize that the PUC, by permitting recovery of prudently incurred costs, properly applied the law to the facts of this case in a manner which prevented an unconstitutional taking. Accordingly, this Court should reverse the judgment below, thereby reinstating the decisions of the PUC which conformed to applicable constitutional standards.

Respectfully submitted,

ROBERT L. BAUM
Counsel of Record
PETER B. KELSEY
EDISON ELECTRIC INSTITUTE
1111 19th Street, N.W.
Washington, D.C. 20036
(202) 778-6500

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No. 87-1160

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

DUQUESNE LIGHT COMPANY
AND
PENNSYLVANIA POWER COMPANY,
Appellants,

v.

DAVID M. BARASCH,
CONSUMER ADVOCATE, *et al.*,
Appellees.

On Appeal from the Supreme Court of Pennsylvania

BRIEF OF PENNSYLVANIA ELECTRIC ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF APPELLANTS

REX E. LEE*
DAVID W. CARPENTER
Sidley & Austin
1722 Eye Street, N.W.
Washington, D.C. 20006
(202) 429-4266

VINCENT BUTLER
RICHARD A. FLATI
DAVID T. EVRARD
Pennsylvania Electric Association
800 N. Third Street
Harrisburg, Pennsylvania 17102
(717) 257-5854

Attorneys for Pennsylvania Electric Association As Amicus Curiae

**Counsel of Record*

QUESTION PRESENTED

Whether a state may constitutionally deny a regulated utility any compensation for prudent expenditures that the utility is statutorily required to incur for the benefit of ratepayers?

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DUQUESNE LIGHT COMPANY
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Appellees.

On Appeal from the Supreme Court of Pennsylvania

BRIEF OF PENNSYLVANIA ELECTRIC ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF APPELLANTS

INTERESTS OF AMICUS CURIAE[1]

The Pennsylvania Electric Association is a trade association of electric utilities. Its members are eleven investor-owned utilities that provide electric service to the public in Pennsylvania.[2] These companies supply approximately 98 percent of the electricity consumed in the state and provide service to approximately 95 percent of the state's residential, commercial, and industrial customers.

[1]Each of the parties to this appeal has consented to the filing of this *amicus curiae* brief. These consents have been filed with the Court.

[2]The members of the Pennsylvania Electric Association are: Citizens' Electric Co., Duquesne Light Co., Metropolitan Edison Co., Pennsylvania Electric Co., Pennsylvania Power & Light Co., Pennsylvania Power Co., Philadelphia Electric Co., Pike County Light & Power Co., UGI Corporation, Wellsboro Electric Co., and West Penn Power Co.

Each member company of the *amicus* association is engaged in transmitting or distributing electricity within designated franchised service areas in the state. Each is regulated by the Pennsylvania Public Utility Commission, which sets the rates for each company. Each company is further under a statutory duty to provide service to any customer in its service area and to construct or obtain generating capacity that is adequate to serve present, and anticipated future, demand. To carry out these statutory duties, each of these utilities must be afforded an opportunity to charge rates that recover all its reasonable expenses as well as provide a reasonable return on investment.

Amicus has a direct and substantial interest in this case. The Pennsylvania Supreme Court has held that a utility may constitutionally be denied recovery of and on a $50 million investment that was reasonably made to carry out a statutory duty, whenever, with the benefit of hindsight, the investment is deemed not to have been "used and useful." The court so held, despite the fact that the electric utilities were also denied any opportunity to be compensated for the risks that such prudent expenditures would be disallowed. The net result is that Pennsylvania has assured that utility investors will not be fairly compensated for their reasonable costs of conducting business, including capital costs. Unless reversed, the Pennsylvania Supreme Court's decision will jeopardize the ability of Pennsylvania utilities to attract capital and provide adequate service to the public.

STATEMENT OF FACTS

A single "stubborn fact" of finance controls this case. Pennsylvania has imposed a duty on electric utilities to make multimillion dollar investments for the benefit of ratepayers, and then denied those utilities—and the investors who own them—any opportunity to be compensated for the costs of complying with that duty.

Electric utilities in Pennsylvania are under statutory obligations to serve any customer within their service areas at state-regulated rates. 66 Pa.C.S. § 1501. To carry out this duty, electric utilities must assure that they will have adequate generating capacity to meet the annual "peak" demands of customers, plus a reasonable reserve margin. Otherwise, there will be "brownouts," "blackouts," and customer service curtailments. When faced with the possibility or probability that future growth in demand may create shortages, Pennsylvania electric utilities do *not* have the option available to firms in unregulated markets. They may not decline to make investments required to meet the anticipated demand on the ground that the likely rewards do not justify the risks. They have the statutory obligation to make affirmative efforts to construct or otherwise obtain sufficient generating capacity.

Pennsylvania made this statutory duty explicit in 1972 and 1973. The Pennsylvania Public Utility Commission was concerned that Pennsylvania electric utilities were not constructing the new plants that would be needed under the then-prevailing forecasts for future growth in customer demand. Those forecasts predicted that demand would continue to grow by five to seven percent annually, as it had since World War II. J.S. App. 16h. The commission ordered Pennsylvania utilities to make "immediate preparations . . . to increase installed capacity until a reliable reserve of 20% above forecasted loads was reached." *Investigation of the Need for Additional Electric Generating and Transmission Facilities*, 46 Pa. P.U.C. 23, 24 (1972).

To carry out their state law duties, Pennsylvania utilities had to act on the basis of forecasts relating to the distant future. This is so because a new generating facility has to be planned 10 to 15 years in advance and requires projections of long-term load growth.[3] In consequence, the only certainty when such projec-

[3]It takes seven to nine years to plan and build a coal fired plant, and ten to twelve years for a nuclear plant. Here, it is undisputed that nuclear power represented the lowest cost alternative for the Pennsylvania utilities when the planning decisions were made. J.S. App. 17h.

tions are made is that they will often turn out to be wrong. For this reason, construction and capacity planning decisions of electric utilities are subject to constant adjustments.

The Pennsylvania Public Utility Commission found—and it is undisputed—that the expenditures that appellants made to carry out the duties imposed by state law were eminently reasonable. Indeed, it would have been imprudent—and threatened ratepayer interests—if the utilities had failed to make these expenditures. In planning the CAPCO nuclear plants, the Pennsylvania utilities acted on the basis of the best information available. They chose what was indisputably the least cost alternative at that time. It was only because of unforeseen, and unforeseeable, changes in circumstances that the plants subsequently appeared to be unnecessary, and that it became prudent to cancel the plants in 1980. J.S. App. 16h-19h.

Moreover, no actual construction ever began. Work on the plant was limited to the preliminary engineering and siting studies that must occur before actual construction can begin. These expenditures put Pennsylvania utilities in a position in which they could have proceeded with the construction of the new plants in 1980 if the plants continued to appear needed. Because intervening events reduced the need for the plants, they could be—and were—prudently cancelled before any construction occurred. J.S. App. 17h-19h. All agree that the engineering and siting costs were prudently incurred, and that the plants were prudently cancelled. *Id.*

Despite these facts, Pennsylvania has now blocked its utilities from receiving any compensation for the over $50 million that appellants reasonably expended on the four CAPCO plants.

The two Pennsylvania utilities were in no way compensated, directly or indirectly, for these expenditures over the eight-year period in which the expenditures were made. The utilities were not allowed to treat the engineering and siting studies as current

"expenses" that would be recovered as outlays were made over this period. Instead, the utilities were required to treat these expenditures as "investments" by "capitalizing" them and recording them in a separate account. The net effect was to exclude these amounts from the utilities' rates during this period and to defer their recovery to a future date. Between 1972 and 1980, rates were set as if the expenditures had never been made between 1972 and 1980.

In this case, the Pennsylvania Supreme Court has construed an intervening Pennsylvania statute to require that present and future rates also be set as if the $50 million had never been spent. It held that expenditures that are not deemed to be currently "used and useful" may not be recovered, regardless of how prudent they were at the time they were made and regardless of any other considerations. Under the court's authoritative construction of the Pennsylvania statute, these expenditures "shall not, in any way whatsoever, be included in the rates charged." J.S. App. 14a. The utilities may not receive a return "of and on" their investment by amortizing it over a period of years and receiving a return on the unamortized balance each year. The utilities may not even receive a return "of" their investment by amortizing it, but receiving no return on the unamortized balance. Nor may these amounts be recovered through any other mechanism.

In contrast, Pennsylvania has sharply limited the ability of utilities to benefit from investments and expenditures that are deemed "used and useful." Under Pennsylvania law, a utility can be, and is, limited to recovery of reasonable out-of-pocket expenses and a return on the net original cost (original cost less depreciation) of the utility's investment—and has no judicially enforceable right to obtain any greater return.[4] Thus, the "rate

[4]The Pennsylvania Supreme Court has held that the Pennsylvania statutes in effect when the rate orders were entered do not entitle utilities to rates that "go beyond [allowing a fair return on the] original cost" of the utility's property, and that there are no statutory or judicially en-

(Footnote continued on next page)

bases" of the two Pennsylvania utilities involved in this case were determined on the basis of each's net original cost. See J.S. App. 3c (adopting "original cost measure of value" to determine utility rate base); 5e (same).

SUMMARY OF ARGUMENT

The Pennsylvania statutory scheme is unconstitutional, both on its face and as applied to the two utilities who are the appellants in this case. Pennsylvania here required its utilities to spend millions of dollars to plan new generating facilities for the benefit of the public and then denied the utilities any form of compensation for prudent expenditures made to carry out this statutory duty. This epitomizes the conduct that it is a *per se* violation of the Fifth and Fourteenth Amendments. See *Armstrong* v. *United States*, 364 U.S. 40, 49 (1960).

Pennsylvania reached this unconstitutional result by confusing two separate and distinct methods of setting utility rates. Under the "fair value"/"used and useful" standard of *Smyth* v. *Ames*, 169 U.S. 466 (1898), utilities are denied any return on investments that are not "used and useful," but are fully compensated for the risk of such disallowances because they are entitled to supernormal returns on other investments. Under the "prudent investment" test of Justice Brandeis, utilities receive a return on

(Footnote continued from previous page)
forceable standards under which a method more favorable to the utility could be required. *Pennsylvania Public Utility Commission* v. *Pennsylvania Gas & Water Co.*, 492 Pa. 326, 424 A.2d 1213, 1221 & 1219-22 (1980), *cert. denied*, 454 U.S. 824 (1981). The utility commission thus lawfully refuses to consider any other method of valuation. *See Barasch* v. *Pennsylvania Public Utility Commission*, 505 Pa. 606, 482 A.2d 1274 (1984), *rev'g, Pennsylvania Gas & Water Co.* v. *Pennsylvania Public Utility Commission*, 72 Pa. Commw. 331, 456 A.2d 1126 (1983).

In 1984, Pennsylvania codified this rule by enacting a statute that provides that the valuation of utility property "shall be the original cost of the property when first devoted to the public service less the applicable accrued depreciation." 66 Pa.C.S. § 1311(b); J.S. App. 201.

all prudent investments, whether or not they are "used and useful," and the utilities cannot receive a supernormal return on any investment, no matter how beneficial. See *State of Missouri ex rel. Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U.S. 276, 289-312 (1923) (Brandeis, J., concurring). See *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944).

Here, Pennsylvania selectively adopted only those elements of each test that disadvantage utilities. Pennsylvania limited utilities to the minimal allowable return on "used and useful" investments (under a prudent investment standard) and denied any return on other prudent investments made for the benefit of ratepayers (under a "fair value" standard). Because it is inevitable that some prudent investments will be deemed not to be "used and useful" —and excluded—the Pennsylvania scheme assures that utilities are not compensated for expenditures, and risks, they are statutorily required to incur. This mixing of distinct methods to guarantee a shortfall is *per se* unconstitutional. See *West Ohio Gas Co.* v. *Public Utilities Commission*, 294 U.S. 63 (1935).

The Pennsylvania Supreme Court's decision is one of many recent state supreme court decisions that rest on the belief that the Federal Constitution authorizes an amorphous "balancing" of a generalized (and boundless) consumer interest in lower rates against an investor interest in having a fair opportunity to recover all prudent costs. That is not, and cannot be, the law.

Amicus submits that there is one approach that will now secure constitutional values and protect this Court's docket: adopt Justice Brandeis's prudent investment test as the constitutional benchmark. The Court should make it explicit that a state may not depart from this approach, unless the state affirmatively demonstrates that it has fairly compensated utility investors for the risk that prudent investments will be disallowed by permitting above-cost returns on other investments. Correlatively, the Court

should reiterate that there is no generalized consumer interest in lower rates that can justify denying utilities an opportunity to recover all amounts prudently invested for the benefit of ratepayers.

ARGUMENT

This *amicus curiae* brief makes two principal points. First, under any view of this Court's prior decisions, the Pennsylvania statutory scheme is unconstitutional, both on its face and as applied to the two appellant utilities. As authoritatively construed by the Pennsylvania Supreme Court, the Pennsylvania statutes deny the two Pennsylvania utilities any possibility of being fairly compensated for expenditures, and risks, that the utilities were under a state-created *duty* to incur for the benefit of the public as a whole. This is a *per se* violation of the Fifth and Fourteenth Amendments. In any event, Pennsylvania's own enactments make it explicit that there is no "consumer interest" or other state interest that could possibly justify this interference with the property rights of utility investors.

Second, the Pennsylvania Supreme Court's decision in this case is a product of the confusion that arises from the coexistence of two separate and distinct means of setting utility rates, each of which is constitutionally permissible when consistently applied. The first is the "fair [market] value"/"used and useful" standard of *Smyth* v. *Ames*, 169 U.S. 466 (1898), and its progeny. It is sound as a matter of theory, but has proven to be impractical of fair and consistent application unless market value is equated with reproduction cost, or some proxy for it. The second is the prudent investment test of Justice Brandeis,[5] which is the foundation of *Federal Power Commission* v. *Hope Natural Gas Co.*,

[5] *State of Missouri ex rel. Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U.S. 276, 289-312 (1923) (Brandeis, J., concurring).

320 U.S. 591 (1944), and its progeny. This test can be readily applied to protect all legitimate investor and consumer interests.

In *amicus's* view, both this case and the experience of the past decade demonstrate that there is now only one way to implement the values of the Fourteenth Amendment in this sensitive and increasingly contentious area: adopt Justice Brandeis's standard as the constitutional benchmark. The Court should make it explicit that utilities are entitled to a fair opportunity to recover all reasonable expenses and to earn a return of, and on, all prudent investment. States should be entitled to depart from the strict prudent investment standard only if they *affirmatively* demonstrate that some other mechanism has been adopted that adequately compensates utility investors for the risks and expenditures they are required to incur. Correlatively, the Court should reiterate that a generalized "consumer interest" in lower rates is not itself sufficient justification for denying a utility an opportunity to earn a return of and on any investment found to be prudent.

I. The Pennsylvania Statutes Violate The Fifth And Fourteenth Amendments.

A. Pennsylvania's Statutory Scheme Is A Per Se Violation Of The Federal Constitution.

The provisions of the Fifth and Fourteenth Amendments that protect private property are "designed to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole." *Armstrong* v. *United States*, 364 U.S. 40, 49 (1960). The Pennsylvania statutes are a stark, clear violation of these provisions. Pennsylvania has imposed a statutory duty on utilities to make massive expenditures for the benefit of the public as whole. Pennsylvania has now adopted rules that assure that even the most prudent of such expenditures will not be recovered from the public "in any way whatsoever" if—as will inevitably sometimes be

the case—the investments can be deemed not to be "used and useful" on the basis of hindsight.

The inevitable "end result" of the Pennsylvania scheme is that Pennsylvania utilities will experience multi-million dollar shortfalls. By simultaneously limiting each utility to a return of and on the original cost of its "used and useful" investments and denying the utility any return of (or on) other prudent investments, the state has guaranteed that the two utilities—and the investors who own them— may not recover their original prudent investment. Here, a $100 million shortfall results solely from the utilities' compliance with a statutory duty imposed for the benefit of the public.[6]

The Pennsylvania scheme would be invalid as applied to any person. It is starkly invalid as applied to a regulated utility.

1. All Firms Must Have The Opportunity To Be Compensated For Carrying Out Statutory Duties That Benefit The Public.

The unconstitutionality of the statutory scheme is vividly demonstrated by the facts of this case. The expenditures were made to carry out a state-created duty. The Pennsylvania utilities did not have the options available to unregulated firms. They were not free to decide that the probable returns from the investments in the CAPCO plants did not justify the risks of proceeding. They had an obligation to make "immediate preparations" to build the plants, and all agree that the utilities acted with the utmost prudence in fulfilling that obligation.

[6]The two utilities' capitalized expenditures exceeded $50 million on the day the plants were cancelled. If the utilities were to recover the present value of that $50 million over ten years, they would have to receive some 100 million in nominal dollars over the ten year period. See J.S. App. 19h-20h. Whatever the method chosen, the utilities will not be "made whole" in an economic sense unless they receive the present value of the $50 million figure.

Further, these "immediate preparations" were ordered precisely because, in the state's judgment, they would confer real and tangible benefits on Pennsylvania consumers, whether or not the plants ended up being built. The engineering and siting expenditures were necessary prerequisites to the actual construction of the new generating facilities that would have been essential if the then-prevailing forecasts of future consumer demand had turned out to be correct. The expenditures were thus akin to an insurance policy purchased for the benefit of ratepayers. The expenditures put the Pennsylvania utilities in a position in which they could have built the plants and met the consumer demand if the forecasts had materialized. The expenditures assured consumers that future demand would be met.

What Pennsylvania has done here is no different from ordering a utility to buy fire insurance for the benefit of ratepayers and thereafter blocking the utility from recovering the premiums on the ground that no fire occurred, and the insurance therefore was not really needed.

This would be a violation of the Fourteenth Amendment even if appellants were not utilities. It is elementary that a state may not constitutionally impose a statutory duty to engage in conduct for the benefit of the public, while prohibiting a property owner from being fairly compensated for the resulting costs. In *Pennsylvania Central Transportation Co.* v. *City of New York*, 438 U.S. 104 (1978), for example, the state landmark law had imposed a statutory duty on the property owner to keep the facade of a landmark building "in good repair." All nine members of the Court agreed that there would have been an unconstitutional "taking" of property if the state were preventing the landowner from recovering the expenses resulting from this obligation, plus a "reasonable return" on investment in the parcel. *Id.* at 120 n.21 & 121 n.23; *accord id.* at 146-47 & n.9 (Rehnquist, J., dissenting on other grounds).

This principle applies with special force to regulated utilities.

2. A Utility May Not Be Denied A Return Of And On Its Prudent Investment Unless It Is Otherwise Compensated For The Risks And Expenditures That It Incurs.

The Pennsylvania Supreme Court's holding rests on a misapprehension of settled law. The court conceded, as it must, that the Federal Constitution would have required Pennsylvania to allow the utilities to earn a return of, and on, the amounts prudently invested in the CAPCO plants if they had been completed and in fact used to provide service to the public. However, it held that the fact that the plants were not built—and are thus not "used and useful"—permits the state to deny any recovery of, or on, expenditures that the utilities were required to make. This holding confuses two distinct methods of protecting the constitutional rights of utility investors: the "fair value"/"used and useful" standard of *Smyth* v. *Ames*, and the prudent investment standard of Justice Brandeis. By selectively adopting only those elements of each test that disadvantage utilities, Pennsylvania has committed a *per se* violation of the Federal Constitution.

The *Smyth* and Brandeis approaches represent two separate and distinct means of implementing the central value protected by the Fifth and Fourteenth Amendments. Each recognizes the legitimacy of the state's interest in regulating public utilities and ordering the devotion of private property to public service. *See Smyth* v. *Ames*, 169 U.S. 466, 546 (1898). The natural monopoly character of aspects of utility businesses creates the possibility of monopolistic pricing and other exploitative practices. Maximum price regulation and the obligation to serve all persons on nondiscriminatory terms can prevent those practices—and operate as a surrogate for the operation of a competitive marketplace.

At the same time, the use of elected or politically-appointed bodies to set the prices at which private property will be used by the public inherently creates the serious possibility that utility investors will be unfairly singled out to bear burdens that the ratepaying public should bear, contrary to the central purpose of

the Fifth and Fourteenth Amendments. Thus, each line of decisions holds that restrictions on utilities must be accompanied by corresponding assurances that the utility will be guaranteed an opportunity to be fairly compensated for the duties, and risks, that it is required to incur. The risks and opportunities for rewards must balance out. That is the regulatory compact.

Smyth v. *Ames*, and its progeny, prescribed one means of striking this constitutional balance. The Court's opinion, authored by the first Justice Harlan, analogized the submission to public utility regulation to a taking of property by eminent domain, and required that rates be set to provide a return of the "fair [market] value" of the physical assets deemed "taken:" that is, the plant that was "used and useful" in the enterprise. 169 U.S. at 546-47. In theory, *Smyth's* "fair value" standard mimics the operation of a competitive market. To the extent utilities' investments in plants are good ones (because they produce benefits in excess of their costs), the utility is "rewarded" with an opportunity to earn an "above-cost" return: that is, a fair return on the "market value" of the plant. To the extent utilities' investments turn out to be bad ones (because the plants are cancelled or abandoned before being fully depreciated or because they were acquired or built at inflated prices), the utilities suffer because a return on the plants' "fair [market] value" is no return, or a below-cost return. Under *Smyth*, the risks and opportunities for rewards are balanced, much as they are in a competitive market.

Whatever its theoretical appeal, the *Smyth* test proved impractical of fair and consistent administration.[7] This was largely be-

[7]A "fair value" test does have one area of easy application: where competition from new technologies (or utility mismanagement) had created a situation where a utility could not recover the original costs of its investment, much less the cost of reproduction, even if its rates were deregulated altogether. In that circumstance, a fair market value could be computed by capitalizing future earnings (or determining salvage value) and setting rates accordingly. The Constitution requires no great-

(Footnote continued on following page)

cause any attempt by a regulator to establish a "fair [market] value" for utility plants is inherently a circular one.[8] As Justice Brandeis demonstrated, "almost any result may be justified" under the *Smyth* v. *Ames* "test."[9] In practical effect, the only way to prevent undercompensating investors was to measure "fair value" based on the reproduction cost of the plants or on some proxy for reproduction cost that can be readily calculated, such as the original cost adjusted for inflation (trended original cost). This Court's opinions thus increasingly required these valuation methods during the 1910s and 1920s.[10] But with high inflation, this interpretation of *Smyth* led to prescriptions of rates that—while

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(Footnote continued from previous page)
er return in such instances, for it is market forces, *not* the state, that prevents a greater recovery. *See Market Street Railway Co.* v. *Railroad Commission of California*, 324 U.S. 548, 566-67 (1945). However, where, as here, the utilities' services are very valuable, and it is state regulation alone that would prevent a utility from recovering all its costs, *Smyth* proved impractical.

[8]As Justice Brandeis explained, a "vicious circle" is inevitable:

> "It is impossible to find an exchange value for a utility, since utilities, unlike merchandise or land, are not commonly bought and sold in the market. Nor can the present value of the utility be determined by capitalizing its net earnings, since the earnings are determined, in large measure, by the rate which the company will be permitted to charge; and, thus, the vicious circle would be encountered."

State of Missouri ex rel. Southwestern Bell Telephone Co. v. *Public Service Commission*, 262 U.S. 276, 292 (1923) (Brandeis, J., concurring). *Accord Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 601 (1944).

[9]*State of Missouri ex rel. Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U.S. at 298 (Brandeis, J., concurring).

[10]*See, e.g., McCardle* v. *Indianapolis Water Co.*, 272 U.S. 400, 410 (1926); *State of Missouri ex rel. Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U.S. at 287-88; *id.* at 289-312 (Brandeis, J., concurring); *Bluefield Water Works & Improvement Co.* v. *Public Service Commission*, 262 U.S. 679, 689 (1923); *Minnesota Rate Cases*, 230 U.S. 352, 434, 454 (1913); *Willcox* v. *Consolidated Gas Co.*, 212 U.S. 19, 41, 52 (1909).

eminently sound as a matter of economics and preferable as a matter of policy[11]—became difficult to defend as constitutional requirements.

The shortcomings of *Smyth* v. *Ames* led Justice Brandeis to develop an alternative approach, which he advocated as the constitutional minimum. He accepted the *Smyth* eminent domain analogy, but concluded that what was "taken" by public utility regulation is not specific physical assets that are to be individually valued, but the capital prudently devoted to the public utility enterprise by the utilities' owners—investors. *State of Missouri ex rel. Southwestern Bell Telephone Company* v. *Public Service Commission*, 262 U.S. at 290 (Brandeis, J., concurring). "The thing devoted by the investor to the public use is not specific property, tangible and intangible, but capital embarked in the enterprise." *Id.* Justice Brandeis urged that "[t]he compensation which the Constitution guarantees an opportunity to earn is the reasonable cost of conducting the business," including the costs of capital that are recovered by allowing a reasonable return on the utility's investment. *Id.* at 291.

> "Cost includes not only operating expenses, but also capital charges. Capital charges cover the allowance, by way of interest, for the use of the capital, whatever the nature of the security issued therefor; the allowance for risk incurred; and enough more to attract capital. The reasonable rate to be prescribed by a commission may allow an efficiently managed utility much more. But a rate is constitutionally compensatory, if it allows to the utility the opportunity to earn the cost of the service as thus defined." *Id.*

Justice Brandeis stated that there is only one limitation that states may constitutionally impose on a utility's opportunity to earn adequate revenues on its actual investment: exclusion of imprudent investment or expenditures. He stated that "the term [prudence is to be] applied for the purpose of excluding what

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[11]*E.g.*, A. Kahn, *The Economics of Regulation*, Vol. I, 109ff (1970).

might be found to be dishonest or obviously wasteful or imprudent expenditures." *Id.* at 289 n.1.

Under Justice Brandeis's net prudent investment test, the historic concept of "used and useful" is irrelevant.[12] The utility must be guaranteed the opportunity to recover all prudent expenses, and earn a return of, and on, all amounts prudently invested in its utility business, irrespective of whether individual investments are deemed necessary or beneficial in hindsight. When prudent investment is the standard, the net result is that utilities have no opportunities for "rewards" (in the form of above-cost returns), because all that is returned is the prudent investment, including capital costs. But the utilities also incur fewer risks. Although a utility always bears the risk that ratepayers will not be willing to pay enough for utility service to cover its cost (see pp. 13-14 n.7, *supra*), the prudent investment test assures the utility the opportunity to recover any investment not found imprudent. This test thus also strikes a constitutional balance.

Justice Brandeis's opinions formed the foundation for *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944). *Hope Natural Gas* both adopted the Brandeis view that "fair value" ratemaking is not constitutionally required and established that the prudent investment test is constitutionally permissible. At the same time, *Hope* held that the Federal Constitution does not require "the use of any single formula or combination of formulae in determining rates." 320 U.S. at 602. This holding reflects the reality that either the prudent investment test of Justice Brandeis, the fair value/used and useful test of *Smyth*, or any other approach that fairly balances risks and rewards can reasonably compensate investors for the duties and risks that they incur,

[12]*State of Missouri ex rel. Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U.S. at 290-91 (Brandeis, J., concurring); *Accord Jersey Central Power & Light Co.* v. *FERC*, 810 F.2d 1168, 1175 (D.C. Cir. 1987) (en banc) (Bork, J.) ("with the demise of 'fair value,' 'used and useful' ceased to have any constitutional significance"); *Washington Gas & Light Co.* v. *Baker*, 188 F.2d 11, 19 (D.C. Cir. 1950) (Bazelon, J.), *cert. denied*, 340 U.S. 952 (1951) (same).

and prevent unconstitutional deprivations of property.[13] The judicial role is to assure that the "end result" will be constitutional under whatever method is employed.

Against this background, the Pennsylvania statutory scheme, as construed by the Pennsylvania Supreme Court, is invalid both on its face and as applied to the two appellants. Because Pennsylvania selectively adopts different elements of two distinct methods, the Pennsylvania scheme is incapable of producing a constitutionally permissible "end result."

West Ohio Gas Co. v. *Public Utilities Commission*, 294 U.S. 63 (1935), is controlling. There, the Court, in an opinion written by Justice Cardozo, held that once a constitutionally permissible method of ratemaking is adopted, it "must be made use of then consistently, and regardless of the consequences." *Id.* at 71. In *West Ohio Gas*, the state commission allocated a utility's costs on one basis in one Ohio city and on a different and inconsistent basis in a second Ohio city served by the same utility. The net result was that rates were reduced in both cities, and the utility was blocked from ever recovering 100% of its expenses. *Id.* at 69-71. That was held to be unconstitutional.

Pennsylvania has mandated the same principle of "heads the utility loses, tails the ratepayer wins." Pennsylvania applies a

[13]Any standard that fairly balances the benefits and burdens of regulation can satisfy constitutional standards. For example, another constitutional approach was suggested in a 1950 opinion for the Court of Appeals for the District of Columbia Circuit, written by Judge Bazelon. See *Washington Gas Light Co.* v. *Baker*, 188 F.2d 11, 15-22 (D.C. Cir. 1950), *cert. denied*, 340 U.S. 952 (1951). It stated that a state commission can constitutionally adopt a "sliding scale" test that retains some reliance on the historic concept of "used and useful" *if* the commission affirmatively compensated the utility for the risk the investment would be disallowed over the period in which it was made by, for example, proving it increased the authorized rate of return for this purpose. There, the court allowed a return of, and on, the investment in an abandoned plant that was not "used and useful" because the commission had not affirmatively provided such compensation. *Id.*

strict fair market value test to "unsuccessful" investments. At the same time, it applies a strict original cost test to successful ones and adopts no other mechanism to compensate utilities for the risks that prudent and statutorily-required expenditures will be disallowed. In short, Pennsylvania has assured that the "end result" of its rate orders can never be fair compensation. This is a *per se* violation of the Fourteenth Amendment.

The Pennsylvania utilities have a federal constitutional right to a recovery of, and on, the over $50 million investment that they prudently made to discharge a statutory duty to the public. During the period in which the investment was made—and thereafter —Pennsylvania did not compensate these (or other) Pennsylvania utilities for the risk that a full recovery of, and on, prudent expenditures would be disallowed even in part. That this order would unconditionally destroy the constitutionally legitimate expectations of the utility could not be clearer.[14]

B. There Is No "Consumer Interest" Or Other State Interest That Could Possibly Justify This Interference With The Property Rights Of Pennsylvania Utility Investors.

The foregoing establishes that the Pennsylvania statutory scheme is a *per se* violation of the Fourteenth Amendment. However, it is apparent, in any event, that there is no "state's interest in [this] regulation" that could justify this interference with property rights. *Keystone Bituminous Coal Association* v. *De*

[14]However, the Court need not decide whether the appellants are entitled to a full recovery of, and on, these investments, for appellants have not challenged the failure to allow a return on the unamortized portions of their $50 million investment and thereby to return this investment in real dollars. Appellants are defending a commission rate order that gives them only a return "of " their investment by amortizing $50 million over a ten year period. There is no basis whatsoever for even a suggestion that Pennsylvania compensated the utilities for the risk that this prudent $50 million investment would be disallowed in its entirety. Indeed, as explained below, Pennsylvania's own actions demonstrate that there is no state interest that could justify such an extraordinary result.

Benedictis, 107 S. Ct. 1232, 1244 (1987); see *Nolan* v. *California Coastal Commission*, 107 S. Ct. 3141, 3146-48 (1987).

The Pennsylvania Supreme Court appeared to rest its decision on the ground that the Federal Constitution allows deprivations of utility property based on some amorphous "balancing" of a generalized "consumer interest" in reduced rates against the investor interest—and that any statute that restrikes this balance is constitutional. That is not, and cannot be, the law.

To be sure, *Hope Natural Gas* recognized that there are "consumer interests" that can constitutionally justify some interference with full realization of the "investor interests"[15] and that reasonable rates can be produced through a "balancing of the investor and consumer interests." *Id.* at 603. However, because all investor interests were fully protected in *Hope*, the Court did not there define the "consumer interests" that are to be balanced. See *id.*

Subsequent decisions make it very clear that the only legitimate "consumer interests" that can be advanced are preventing the utility from recovering truly imprudent investments or recovering amounts *in excess of* those required fairly to compensate utilities

[15]*Hope Natural Gas Co.* recognizes constitutionally protected "investor interests" that are far broader than those that Justice Brandeis discussed; they include a market return of and on all capital, with no stated limitation to prudent investment (320 U.S. at 603):

> "[T]he investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. Cf. *Chicago & Grand Trunk Ry. Co.* v. *Wellman*, 143 U.S. 339, 345-346. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."

and their investors for the duties and risks that they incur.[16] To hold that there is a generalized (and boundless) consumer interest in having lower and more affordable rates and that this interest justifies reducing rates below the levels that represent the constitutional minimums would sanction unconstitutional deprivations of property. See *Pennell* v. *City of San Jose*, 108 S. Ct. 849, 861-64 (1988) (Scalia, J., concurring in part and dissenting in part on other grounds).

However, the Court need not address that issue to decide this case. Pennsylvania's own actions demonstrate that there is no consumer interest, or other state interest, that can justify the interference that occurred. The decisive fact is that Pennsylvania, by statute, has now authorized the recovery of, but not on, investment in any plant that is cancelled after 1985. This statute vitiates any claim that there is a "consumer" or other sufficient state interest that is served by denying any and all recovery of prudently-incurred investments in cancelled plants.

As authoritatively construed by the Pennsylvania Supreme Court, Pennsylvania law is now as follows. A utility that prudently expended $100 million in planning a plant over the period from 1972 to 1986 is entitled to receive a return of the $100 million in its rates because it gets the benefit of the 1985 statute. In contrast, a utility that prudently expended $50 million in planning a plant

[16]*See, e.g., Federal Power Commission* v. *Memphis Light, Gas & Water Division*, 411 U.S. 458, 474 (1973) ("under *Hope Natural Gas* rates are 'just and reasonable' only if consumer interests are protected *and* if the financial health of the pipeline in our economic system remains strong") (emphasis added); *Colorado Interstate Gas Co.* v. *FPC*, 324 U.S. 581, 605 (1945) ("end result" test "is not a standard so vague and devoid of meaning as to render judicial review a perfunctory process. It is a standard of finance resting on stubborn facts"); *Permian Basin Area Rate Cases*, 390 U.S. 747, 792 (1968) (a court must assure itself that "the order may reasonably be expected to maintain financial integrity, attract necessary capital, *and* fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable") (emphasis added).

over the period from 1972 to 1980 does not receive a nickel of the $50 million because the 1985 statute is inapplicable. No one has—or could—identify any basis for this difference in treatment. The investor interest is identical in each case: to be made whole for statutorily-required expenditures. If the generalized "consumer interest" in "lower rates" is a valid one, it applies with *greater* force in the case of the $100 million investment that is allowed than in the $50 million investment that is excluded.

This Court's decisions under the Taking Clause establish that the "dispensation" that Pennsylvania extends to plants cancelled after 1985 forecloses any reliance on "consumer interests" to justify the restrictions at issue in this case. In this respect, the case is controlled by *Nollan* v. *California Coastal Commission*, 107 S. Ct. 3141, 3148 (1987). As in *Nollan*, what Pennsylvania has done is the "same as if [Pennsylvania] law forbade shouting fire in a crowded theater, but granted dispensations to those willing to contribute $100 to the state treasury." 107 S. Ct. at 3148. As in *Nollan*, the presence in this case of a "dispensation" that is wholly unrelated to and inconsistent with the purported statutory justification forecloses a decision that the state interest is sufficient to justify what would otherwise be a clearly unconstitutional taking of property.

II. The Court Should Adopt The Brandeis Prudent Investment Standard As The Constitutional Benchmark.

The Pennsylvania Supreme Court's decision in this case is one of many recent state court decisions that have seriously tested, if not transgressed, the constitutional prohibition against the taking of property without just compensation, and these and similar decisions are imposing increasing burdens on this Court's docket.[17] They all rest on a widespread misinterpretation of the

[17]*See, e.g., Kansas Gas & Electric Co.* v. *State Corp. Commission*, 239 Kan. 483, 720 P.2d 1063 (1986), *probable jurisdiction noted*, 107 S. Ct. 1281, *appeal dismissed under Rule 53*, 107 S. Ct. 3280 (1987); *Citizens*

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Court's prior pronouncements, and, in particular, on the belief that the Federal Constitution authorizes an amorphous, ad hoc balancing of a boundless "consumer interest" in lower rates against the interest of utility investors in having a fair opportunity to recover all their costs. The confusion has even led the Federal Energy Regulatory Commission recently to assert that rate orders —and the criteria on which they are based—are unreviewable.[18] The Court disavowed that view over 40 years ago.[19]

The confusion persists precisely because there are several methods of ratemaking that, at least in theory, would fully protect the ultimate constitutional interest. See pp. 12-17, *supra.* The multiplicity of possible approaches has produced the same problem that led to Justice Brandeis's criticisms of the rule of *Smyth* v. *Ames*. See pp. 13-14, *supra*. Today, a state legislature, regulatory commission, or court can justify "almost any result" it wants to reach by selectively adopting different aspects of different approaches. That is what the Pennsylvania legislature and court have done here. Indeed, the problem today is far more serious than the one that Justice Brandeis faced because, whatever its

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Action Coalition of Indiana, Inc. v. *Northern Indiana Public Service Co.*, 485 N.E.2d 610 (Ind. 1985), *appeal dismissed and cert. denied*, 476 U.S. 1137 (1986); *Cleveland Electric Illuminating Co.* v. *Public Utilities Commission*, 4 Ohio St. 3d 107, 447 N.E.2d 746, *appeal dismissed*, 464 U.S. 802 (1983); *Cleveland Electric Illuminating Co.* v. *Public Utilities Commission*, No. 82-165 (Ohio, July 7, 1982), *appeal dismissed*, 459 U.S. 1094 (1983); *Office of Consumers' Counsel* v. *Public Utilities Commission*, 67 Ohio St. 2d 153, 423 N.E.2d 820 (1981), *appeal dismissed*, 455 U.S. 914 (1982); *see also Petition of Public Service Commission of New Hampshire*, No. 87-311 (N.H. Jan. 26, 1988); *Toledo Edison Co.* v. *Public Utilities Commission*, 12 Ohio St. 3d 143, 465 N.E.2d 886 (1984).

[18]See *Jersey Central Power & Light Co.* v. *FERC*, 810 F.2d 1168, 1174 (D.C. Cir. 1987) (en banc) (quoting one FERC submission).

[19]*Colorado Interstate Gas Co.* v. *FPC*, 324 U.S. 581, 605 (1945) ("end result" test "is not a standard so vague and devoid of meaning as to render judicial review a perfunctory process. It is a standard of finance resting on stubborn facts.")

other deficiencies, *Smyth* v. *Ames* was generally implemented to err on the side of protecting constitutional rights. See p. 14 & n.10, *supra*.

Against this background, *amicus* submits that the appropriate approach, both to secure constitutional values and to protect this Court's docket from the burden of reviewing the details of a plethora of rate decisions, is to adopt the prudent investment test of Justice Brandeis as the constitutional benchmark. That test protects investor interests by providing for a return on actual prudent net investment and recovery of all prudent expenses. It also protects all legitimate consumer interests by authorizing the exclusion of wasteful and imprudent expenses.

By making Justice Brandeis's approach the benchmark, the Court would not foreclose individual states from adopting different approaches. However, the Court would make it clear that a state cannot disallow all, or some, of a prudent investment, unless it first affirmatively demonstrates that some other mechanism has been provided to compensate utility investors for that risk: by authorizing above-cost return on other investments or otherwise. See p. 17 n. 13, *supra.*

At the same time, the Court need not now foreclose the possibility that there are, or could be, other state interests that would justify denying utility investors a fair return. However, it should reject any notion that a generalized "consumer interest" in lower, and more affordable, rates can be such a factor. Consumers have a legitimate interest in paying rates that exclude truly wasteful and imprudent expenditures. They also have an interest—which is the foundation for rate regulation of natural monopolies—in preventing monopoly pricing and prohibiting discriminatory and exploitative practices. But when these interests are safeguarded—as they are under the prudent investment test or any constitutional surrogate—further rate reductions in the name of some amorphous "consumer interest" is a taking of investor property. See pp. 19-20, *supra*.

CONCLUSION

For the reasons stated, the judgment of the Pennsylvania Supreme Court should be reversed.

Respectfully submitted,

REX E. LEE*
DAVID W. CARPENTER
Sidley & Austin
1722 Eye Street, N.W.
Washington, D.C. 20006
(202) 429-4266

VINCENT BUTLER
RICHARD A. FLATI
DAVID T. EVRARD
Pennsylvania Electric Association
800 N. Third Street
Harrisburg, Pennsylvania 17102
(717) 257-5854

Attorneys for Pennsylvania Electric Association As Amicus Curiae

May 5, 1988

**Counsel of Record*

(10)

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1987

DUQUESNE LIGHT COMPANY,
AND
PENNSYLVANIA POWER COMPANY Appellants,

V.

DAVID M. BARASCH, CONSUMER ADVOCATE, et al.
Appellees.

On Appeal from the
Supreme Court of Pennsylvania

BRIEF FOR THE NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES AS AMICUS CURIAE

STEVEN W. HAMM
Consumer Advocate
South Carolina
Co-Chairman
NASUCA's Electric
Committee

RAYMON E. LARK, JR.*
Ass't Consumer
Advocate
Co-Chairman
NASUCA'S Electric
Committee

National Association
Of State Utility
Consumer Advocates
So. Carolina Depart.
of Consumer Affairs
2801 Devine Street
Post Office Box 5757
Columbia, SC 29250
(803) 734-9464

WILLIAM J. HERRMANN
Chief Counsel for
Illinois Governor's
Office of Consumer
Services
NASUCA Members
SUE A. HERRMANN
NANCY GAITSKILL
of Counsel

*Counsel of Record

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QUESTION PRESENTED

Whether a state may constitutionally require utility property to be used and useful in providing service to ratepayers before the property is included in the utility's rates?

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No. 87-1160

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1987

DUQUESNE LIGHT COMPANY,
AND
PENNSYLVANIA POWER COMPANY Appellants,

V.

DAVID M. BARASCH, CONSUMER ADVOCATE, et al.
Appellees.

On Appeal from the
Supreme Court of Pennsylvania

BRIEF FOR THE NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES AS AMICUS CURIAE

INTEREST OF AMICUS CURIAE

The National Association of State Utility Consumer Advocates (NASUCA) files

this brief as amicus curiae in support of appellees. NASUCA members represent electric consumers in thirty-seven states and the District of Columbia. NASUCA urges this Court to affirm the decision of the Supreme Court of Pennsylvania. A reversal will have a dramatic, immediate, and negative impact on the traditional scope of state regulation of investor-owned public utilities. Those participating as consumers and advocates for consumers in a changed state regulatory process will be detrimentally affected. NASUCA submits this brief with the consent of the parties, and files written verification of this with the Clerk pursuant to Supreme Court Rule 36.2.

SUMMARY OF ARGUMENT

A monopoly status was granted to electric utilities in the belief that these

utilities were natural monopolies. In return for the privileged monopoly status, electric utilities are subject to government regulation. The purpose of regulation is to be a surrogate for competition in determining just and reasonable rates. In fulfilling its function, regulation must balance the conflicting interests of both the consumer and the investor.

To accomplish this difficult task, regulation has developed certain regulatory principles. Perhaps the most important of these principles is that rates must be determined only on a utility's investment actually providing a service to the ratepayer. The exclusion of property not used and useful from a utility's rates results in an equitable allocation of

risks between consumers and investors, and is necessary in order to provide incentives to a utility to operate efficiently.

This Court has never interpreted the Constitution to establish an investor right to receive a profit on property that has no value in serving the public. The Pennsylvania Supreme Court's decision in upholding a Pennsylvania law prohibiting the inclusion of cancelled plant in a utility's rates was proper. Cancelled plant has no value and the recognition of this obvious fact is entirely appropriate. This Court has ruled many times that due process only prevents destruction of value by government action and cannot be applied to restore values that have been lost by the operation of economic forces.

ARGUMENT

THE REGULATORY PRINCIPLE OF USED AND USEFUL IS A CONSTITUTIONALLY VALID REGULATORY TOOL.

A. UTILITIES ENJOY A PRIVILEGED MONOPOLY STATUS

This Court in United Fuel Gas Co. v. Railroad Commission of Kentucky, 278 U.S. 300, 309 (1929), observed that a regulated public utility exercises an extraordinary privilege and occupies a privileged position as compared to other profit motivated private enterprises. Under regulation a public utility is granted a monopoly status and is sheltered against many of the hazards to which the unregulated business is subject.

History shows that as the electric industry developed in this country, individual state legislatures gradually determined that electric companies were natural monopolies and that it was in society's interest to grant them a monopoly status. It was widely believed that competition between electric companies could interfere with efficient supply of the service. At the same time, the economics of producing electricity, at least in the early days, indicated that the industry was on a decreasing cost basis - the more a company produced the less its cost of production.

In this context legislators disregarded one of the basic premises of a free enterprise system: that free competition resulted in the best allocation of society's resources and resulted in a

fair price for an adequate output of goods. They allowed electric companies to become monopolies. In utility regulation the privileged monopoly status is conveyed to the private utility in return for the utility's obligation to provide reliable service to the public.

However, government regulation was needed to offset the natural tendency of a monopoly to be inefficient and exhibit other behavior inimical to the public interest, i.e., reducing output in order to extract a higher price. Therefore electric utilities, in return for their state created monopoly status, are regulated by the state.

The goal of utility regulation is to determine rates that would result from free competition if free competition were possible. The regulator has the difficult

and complex role of determining rates that are just and reasonable from both the captive ratepayer and investor perspectives.

The interest of the consumers in receiving the best service at the lowest rates possible and the profit motive of the investor are at odds in this case. The public interest in not being required to pay for something that will never have any value to them nor ever be useful to any segment of society, far outweighs the investor interest in receiving a profit on a failed investment. The Pennsylvania legislature and the Pennsylvania Supreme Court concluded similarly.

Regulators have to balance these interests in a continually changing economic atmosphere. Generally speaking,

though, a utility is entitled to rates which provide an opportunity to yield revenues sufficient to meet operating expenses, taxes, and provide a fair return on its rate base. Rate base is defined as the dollar value of a company's plant and equipment that is serving the public. Iowa-Ill. Gas and Electric v. Iowa S. Com Comm'n, 347 N.W.2d 423 (Iowa 1984). A utility is entitled to a reasonable profit or rate of return on this used and useful property, so long as it was procured under conditions of prudent and efficient management.

Rate of return is the cost to the utility of its financing incurred to produce its plant and equipment. Rate of return has three components - cost of debt, preferred stock, and equity or common stock. In any determination of rate of

return, the cost of debt and preferred stock are fixed amounts and their values can be determined by simple arithmetic. The cost of equity basically determines the profit the utility will be allowed to earn. By its very nature this determination is subjective and depends upon what regulators perceive to be a fair return or profit on investment. Implicit in an allowed rate of return is a risk premium. The risk premium compensates the investor for the risk that his investment may be unsuccessful.

Within the context of this ratemaking formula, regulation has to fulfill its function as a substitute for competition. Regulation must not only prevent the utility from charging excessive rates, impairing the quality of its service and

earning excessive profits; but it must also provide incentives to improve quality and to increase efficiency. Even though this goal of regulation is clear and indisputable, achieving it is extremely difficult. Regulatory agencies can neither acquire nor effectively utilize the range of data which influence a competitive market.[1] The difficulties of regulation are largely inherent in the nature of the undertaking itself. "It cannot prescribe quality, force efficiency, or require innovation, because such action would invade the sphere of management. But when it leaves these matters to the discretion of industry, it denies consumers the protection that competition would afford."[2]

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1 Phillips, The Regulation of Public Utilities: Theory and Practice (1985) at 154, quoting from former FCC chairman, Lee Loevinger, Regulation and Competition as Alternatives, 11 The Antitrust Bulletin 101, 125 (1966).

2 Wilcox, Public Policies Toward Business (3d ed.), at 476-77.

B. THIS COURT, STATE SUPREME COURTS, AND REGULATORY BODIES CONSTITUTIONALLY UTILIZE THE USED AND USEFUL PRINCIPLE.

Realizing that public utility regulation is inherently incapable of supplying the kind of continuous pressure and incentives for the efficient operation of a utility that competition ordinarily supplies in non-regulated industries, several states have developed regulatory principles to compensate for the lack of competition. One widely accepted principle is that rates must be determined only on an investment actually providing a service to the ratepayer or on property that is used and useful. The used and useful principle balances the interests between the ratepayer and investor by protecting the consumer from unnecessary or excessive investment while allowing investors a

return on the capital which they have reasonably devoted to public use. The used and useful test serves to measure precisely how much property is devoted to the public for which a return can be expected. Beginning with Smyth v. Ames, 169 U.S. 466 (1898), this Court found that a utility is entitled to a return upon that property which is used and devoted by it to the public convenience. On the other hand, property which is not used and useful for the public convenience is not to be included as a basis for making rates. Denver Union Stock Yard Co. v. United States, 304 U.S. 470, 475 (1938). The used and useful test has been accepted by the vast majority of jurisdictions as a means of distinguishing between property included in rates and property appropriately excluded.

Some jurisdictions apply the used and useful test in conjunction with the requirement that the investment be

prudent.[3] With respect to the prudence requirement, it is clear that ratepayers are not to be charged for negligent, wasteful or improvident expenditures, or for the cost of management decisions which are not made in good faith. Reagan v. Farmers' Loan & Trust Co., 154 U.S. 362, 412 (1894). Ratepayers are not expected to pay for management's lack of honesty or sound business judgment. Missouri ex rel. S.W. Bell Tel. Co.v. Pub. Serv. Comm., 262 U.S. 276, 290 n.1 (1923) (Brandeis, J. concurring). This Court has never held, however, that a utility reglatory agency is limited solely to a prudence analysis. Communications Satellite Corp. v. FCC, 611 F2d 883, 890 (D.C. Cir. 1977).On the

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3 The prudent investment test is widely credited to Mr. Justice Brandeis. Whether he intended to limit a regulatory body to this test is questionable. He developed this test with the history of the railroads in mind. As he explained, this history was replete with examples of fraud on ratepayers. See infra note 8.

contrary, it is simply one of several tools available to the regulator.

Even if the prudence test is used, the investigation into what property should be included in rates cannot realistically end with that analysis as appellants argue. A competitive market does not differentiate between prudent and imprudent investments. The market provides rewards and penalties based on the result of the investment decision. In a competitive market, firms that cancel partially completed plants for lack of demand do not recover their investments. The harsh consequences of misjudgments in the competitive market provide powerful incentives for prudent decisionmaking.

Moreover, this Court has long held that prudently incurred property could be excluded from rates. In Los Angeles Gas and Electric Corp. v. Railroad Commission of California, 289 U.S. 287 (1933), the

Court considered whether a plant designed to manufacture natural gas which was no longer in use should be included in rate base. The Court noted:

> The time and circumstances of the outlay, and the effect of altered conditions, demand consideration. Even when cost is revised so as to reflect what may be deemed to have been invested prudently and in good faith, the investment may embrace property no longer used and useful for the public.

Id. at 306.

Similarly, in Federal Power Commission v. Natural Gas Pipeline Co., 315 U.S. 575 (1942), where natural gas producers alleged that the exclusion of excess plant capacity from rate base was confiscatory, the Court stated that there was no constitutional right to the inclusion of this value as a separate item. Rather, it is "only on the

assumption that excess capacity is a part of the utility's equipment used and useful in the regulated business, that it can be included as a part of the rate base on which a return may be earned." 315 U.S. at 590. Also, in Permian Basin Area Rate Cases, 390 U.S. 747 (1968), producers of natural gas attacked the Federal Power Commission's failure to include an adequate allowance for exploration costs. Rejecting the claim outright, the Court stated: "We must emphasize that we perceive no obligation upon the Commission, under the Constitution or the Natural Gas Act, to permit recovery of all exploration costs, regardless of their amount and prudence." 390 U.S. at 825 n.115. Indeed, in Market Street Railway Co. v. Railroad Commission, 324 U.S. 548 (1945), this Court rejected the proposition that every prudent

investment must be included in rates. 324 U.S. at 567. See also infra at 40-42; Denver Union Stock Yard Co. v. United States, 304 U.S. 470, 476 (1938).

In Tennessee Gas Pipeline Co. v. Federal Energy Regulatory Commission, 606 F.2d 1094 (D.C. Cir. 1979), the issue was whether FERC had properly excluded certain investments from rate base. The Court asserted that the investment must be used and useful. "These investments were prudent investments, argues Transco; however, for rate base inclusion expenditures must satisfy not only the necessary condition of prudent investment but also must be 'used and useful' in providing service." Id. at 1123. Accord, NEPCO Municipal Rate Committee v. Federal Energy Regulatory Commission, 668 F.2d 1327, 1333 (D.C. Cir. 1981).

Many state courts and commissions have recognized the validity of the used and useful test in addition to an analysis of prudency.[4] Typical of the analysis is

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[4] Iowa-Ill. Gas and Electric v. Iowa S. Com Comm'n, 347 N.W.2d 423, 429 (Iowa 1984); Madison Gas and Electric Co. v. Public Service Commission of Wisconsin, 325 N.W.2d 339 (Wis. 1982); Philadelphia Electric Co. v. Pennsylvania Public Utility Commission, 61 Pa. Commw. 320, 433 A.2d 620 (1981); Public Service Commission v. Montana-Dakota Utilities Co., 100 N.W.2d 140, 150 (N.D. Sup. Ct. 1959); Re Kansas City Power and Light Co., 75 PUR 4th 1, 125 (Mo. Pub. Serv. Comm'n. 1986); Pa. PUC v. Pennsylvania Power and Light, 67 PUR 4th 30 (Pa. Pub. Util. Comm'n. 1985); Arkansas Power and Light Co., 66 PUR 4th 167, 183 (Ark. Publ. Serv. Comm'n. 1985); Washington Utility and Transportation Commission v. Pacific Power and Light Co., 51 PUR 4th 158, 167 (Wash. Ut. & Tr. Comm. 1983); Re Consumers Power Co., 14 PUR 4th 1, 15 (Mich. P.S.C. 1976); Re Tampa Electric Co., 92 PUR 3d 398, (Fla. P.S.C. 1971); Re The Chesapeake and Potomac Telephone Co., 57 PUR 3d 1, 6 (D.C. P.S.C. 1964); Mayor of City of Everett v. Malden and Melrose Gas Light Co., 78 PUR (NS) 129, 132-33 (Mass. D.P.U. 1949); City of Bend v. Bend Water, Light, and Power Co., PUR 1915F 913, 917 (Ore. P.S.C. 1915).

Re Iowa-Illinois Gas and Electric Co., 46 PUR 4th 616 (Iowa S.C.C. 1982). There the Iowa Commission expressly rejected sole reliance upon the prudence standard urged by the utility.

> The "prudency" test Iowa-Illinois advocates would, taken to its logical extreme, require us to allow Iowa-Illinois a full return on any amount of capacity, regardless of the consequences to the consumer, so long as the decision to invest in that amount of capacity was justified at the time it was made. We do not believe the prudency test Iowa-Illinois advocates is consistent with sound regulatory principles.

Id. at 618.

In cases like the instant one involving cancelled plants, the used and useful principle is indispensable to protect consumers. The Supreme Court of Indiana, in Citizens Action v. Northern Indiana Public, 485 N.E.2d 610 (Ind. 1985),

noted the long-standing history of evaluating property that is used and useful in rate base. Id. at 614. Upholding the disallowance of cancelled plant from rate base, the court said:

> [W]e have been unable to conceive of a situation ... in which the consumers could be required to replenish lost capital which had never become "used and useful" property or, in other words, be required to act in aid and support of the utility as an insurer of the investor's risk, unless consumers received an interest in return which provided an opportunity to earn a return on the capital supplied.

Id. at 615.

The foregoing history establishes that the used and useful standard is key to determining rates that balance ratepayer and investor interests. Appellants' argument to the contrary is simply without merit. Although the prudence standard may be appealing in theory, it is extremely unfair to limit a regulatory body solely to

that standard. There are practical problems with it, beyond proper regulatory principles, that militate against the sole application of the prudence standard. Demonstrating the prudence and/or imprudence of a utility's decision to construct a new plant requires enormous expenditures for expert witnesses. Generally litigation costs of this magnitude are beyond the reach of most consumer groups and regulatory bodies. Even the Federal Energy Regulatory Commission (FERC) has noted that it does not have sufficient resources to determine whether a utility has acted prudently in deciding to build a particular plant.[5]

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5 Pierce, The Regulatory Treatment of Mistakes In Retrospect: Cancelled Plants and Excess Capacity, 132 U. Pa. L. Rev. 496, 512 nn.80, 81 (1984). Even in light of this Court's decision in Mississippi Power and Light Co. v. State of Mississippi on June 24, 1988, FERC's responsibility to conduct prudence reviews remains unclear and may require Congressional action.

Additionally, in regard to a utility's decisions in constructing a new plant, regulatory review may not occur until ten or fifteen years after the decision. This length of time makes it extremely difficult to gather the data and evidence necessary to show imprudence as well as prudence.

The other argument by the appellants and amici for them that the used and useful principle can only be applied in conjunction with the fair value method of determining rate base is spurious. They cite no authority for this proposition because this distinction has never been made in any of the numerous cases which applied the used and useful standard. The basis of the argument seems to be that a fair value rate base enables a utility the opportunity to earn more dollars and thereby be compensated for any potential used and useful disallowance.

This perception is false. History shows that a fair value determination could either increase or decrease the value of a utility's rate base. The value will constantly fluctuate in accordance with economic cycles and trends. Given a different economic climate, appellants might have to change their position and argue that the used and useful standard can only be applied to original cost.

It was precisely because of the difficulty in determining fair value that this Court discarded this imprecise valuation, and ruled that it would no longer be constitutionally mandated. Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944). The Court wisely removed itself from a debate that one commentator at the time described as follows:

> The subject of valuation in the regulatory field probably has engendered more disagreement and contrariety of opinion, and has strained more friendships, than any other subject with the possible exceptions of religion, politics and the keen dispute over the authorship of the works attributed to William Shakespeare. One might say, with the full support of regulatory history, that valuation comes close to what might be truly characterized or described as institutionalized uncertainty.[6]

The exclusion of property not used and useful results in an equitable allocation of risks between consumers and investors, and provides adequate incentives for efficient operation. The utility's profit stems from receiving a rate of

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6 McKeage, Public Utility Regulatory Law 63 (1956).

return on its rate base: the larger the rate base, the higher the potential profits for the utility. This results in a natural incentive for utilities to build large, capital intensive plants.[7] The most dangerous problem of including plant not used and useful in rate base is that it perpetuates this inappropriate incentive. If a utility knows that its investments in future plants will be included in rate base even if cancelled prior to completion, it is more likely that the utility will fail to exercise sufficient caution in planning its construction program. A return on cancelled plant removes a necessary constraint on a utility to control the costs and size of a construction program. Regulatory bodies that utilize a used and

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7 Pierce, supra, at 506; Schwartz, Inflation and Utility Rate Regulation, 4 Utah L. Rev. 89, 93 n.9 (1982)

useful test are fulfilling their obligation to determine fair and reasonable rates in light of their role as surrogates for competition.

C. HOPE: ITS PREDECESSORS AND PROGENY DO NOT ESTABLISH A CONSTITUTIONAL RIGHT TO RETURN OF OR ON PROPERTY THAT IS NOT USED AND USEFUL.

The statute at issue here, 66 Pa. Cons. Stat. § 1315 (1982), like many state statutes and regulatory practices, disallows the cost of any plant not used and useful. Appellants allege that the statute and the Pennsylvania Supreme Court's intrepretation of the statute amounts to a taking of the utility's property in violation of the 5th Amendment of the United States Constitution. A review of the cases before this Court

establishes that the denial of these costs does not rise to the level of a "taking."

In 1877, in Munn v. Illinois, 94 U.S. 113 (1877), this Court upheld the right of the State of Illinois to regulate the prices charged to farmers for the storage of grain in grain elevators. The Court there recognized that the public interest may override the interests of private enterprise. In Munn, a small number of elevator operators had a "virtual monopoly" and openly set uniform prices. 94 U.S. at 131. The Court held that businesses "affected with a public interest" were subject to control, i.e., price regulation, under the general police power in order to protect the public. 94 U.S. at 126.

Seventeen years later, in Reagan v. Farmers' Loan & Trust Co., 154 U.S. 362 (1894), the Court held that under the power

of eminent domain, if the state were to take the appellant's (here a railroad's) property, it would have to pay compensation. Similarly, taking the use of the property for public benefit at less than its market value was equally a taking. 154 U.S. at 410. The Court emphasized, however, that:

> It is unnecessary to decide, and we do not wish to be understood as laying down as an absolute rule, that in every case a failure to produce some profit to those who have invested their money in the building of a road is conclusive that the tariff is unjust and unreasonable. And yet justice demands that everyone should receive some compensation for use of his money or property, if it be possible without prejudice to the rights of others.

154 U.S. at 412.

Shortly after Reagan, in Covington & Lexington Turnpike Co. v. Sandford, 164 U.S. 578 (1896), the Court required turnpike rates high enough to pay dividends, but only if there was no proof that the public interest justified lower rates. There was no unconstitutional taking if the low rates reflected the value to the public of the company's service, the imprudence of investment, or losses caused by competition. 164 U.S. at 596-97.

The principles of Reagan and Sandford culminated in Smyth v. Ames, 169 U.S. 466 (1898). In Smyth, the Court reiterated the principle of Sandford that rates should reflect the value of service to the public. The Court rejected the plaintiff railroads' argument that would have required the regulators in setting rates to use the historical book value of the

railroad property, an amount far more than the reproduction cost of the railroad facilities because of the depressed economy of the late 1800's and because of excessive construction contracts, imprudent financing and watered stock.[8] Instead, the Court adopted a rule that set rates at a level that covered operating expenses and provided a "fair return" on the "fair value of property being used by it for the convenience of the public." 169 U.S. at 546, 547.

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8 Missouri ex rel. S.W. Bell Tel. Co. v. Public Service Commission, 262 U.S. 276, 298 (1922) (Brandeis, J., concurring); Drobak, From Turnpike to Nuclear Power: The Constitutional Limits on Utility Rate Regulation, 65 Boston U.L.R. 65, 77-78 nn. 52, 53 (1985).

> What the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience. On the other hand, what the public is entitled to demand is that no more be exacted from it for the use of a public highway than the services rendered by it are actually worth.

Id. at 546-47. Although the Court listed many factors to be considered in determining fair value, subsequent cases reduced those factors to the reproduction cost at the time of the rate hearing. See, e.g., Missouri ex rel. S.W. Bell Tel. Co. v. Public Service Commission, 262 U.S. 276, 290, 298 (1922).

While reproduction cost was favorable to the public as applied to inflated railroad construction costs during depressed economic times, the situation

reversed during the inflationary period of World War I.[9] In addition, replacement cost failed to be the definite, calculable number that regulating authorities had desired. These woes were eloquently voiced by Mr. Justice Brandeis in his concurring opinion in Missouri, ex rel. S.W. Bell Tel. Co. v. Public Service Commission, 262 U.S. 276 (1923) There he advocated laying to rest the Smyth reproduction cost rule and allowing the utility to earn "a fair return on the amount prudently invested in it." 262 U.S. at 289. While attacking the Smyth rule on the basis of its historical foundations, which were no longer applicable, and the fact that it

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9 Missouri ex rel S.W. Bell Tel. Co. v. Public Service Commission, supra note 8 at 299-301 (1923) (Brandeis, J., concurring); Drobak, supra at 81, n.8.

was unworkable in practice, Mr. Justice Brandeis also changed the constitutional inquiry from the prevailing eminent domain philosophy of taking the utility's property to that of taking the investors' capital. 262 U.S. at 290.[10]

> The thing devoted by the investor to the public use is not specific property, tangible and intangible, but capital embarked in the enterprise. Upon the capital so invested the Federal Constitution guarantees to the utility the opportunity to earn a fair return.... The Constitution does not guarantee to the utility the opportunity to earn a return on the value of all items of property used by the utility, or any of them.

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10 Drobak, supra, at 82.

262 U.S. at 290. He defined a constitutionally adequate rate level as:

> The compensation which the Constitution guarantees an opportunity to earn is the reasonable cost of conducting the business. Cost includes not only operating expenses, but also capital charges. Capital charges cover the allowance, by way of interest, for the use of capital, whatever the nature of the security issued therefore; the allowance for risk incurred; and enough more to attract capital.

262 U.S. at 291. While this measure was intended to eliminate the vagaries inherent in the Smyth test,[12] it made two

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12 Reproduction cost necessarily varies with the cost of labor, materials and capital and other economic conditions.

assumptions. First, it assumed that any investment, short of dishonesty or obvious waste, was prudent. "Every investment may be assumed to have been made in the exercise of reasonable judgement, unless the contrary is shown." 262 U.S. at 289 n.1. Second, it assumed that the property in question was being used to provide service to ratepayers.

> [T]he cost to the utility of the capital, required to <u>construct, equip and operate</u> its plant, should measure the rate of return which the constitution guarantees opportunity to earn [footnote omitted].... It would, when once made in respect to any utility, be fixed for all time, subject only to increases to represent additions to plant....

<u>Id</u>. at 306-07 (emphasis added).

The <u>Smyth</u> test, however, lingered until the 1940's, when the Court released

regulators from their obligation to use any one test in <u>Federal Power Commission v. Natural Gas Pipeline Co.</u>, 315 U.S. 575 (1942), and <u>Federal Power Commission v. Hope Natural Gas Co.</u>, 320 U.S. 591 (1944). Both cases involved the constitutionality of the Natural Gas Act of 1938, 15 U.S.C. §§ 717, <u>et seq.</u>, which allowed the Federal Power Commission to set rates to be charged for the sale of natural gas. In <u>Natural Gas Pipeline</u>, the Court held that "[t]he Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas." 315 U.S. at 586. Agencies could adjust to specific circumstances as long as they acted within their statutory authority, and as long as the final order, "viewed in its entirety," did not produce an arbitrary result, the Constitutional inquiry ended. <u>Id</u>.

Regulation "does not insure that the business shall produce net revenues." 315 U.S. at 590.

Shortly after, in Hope, where the company challenged a commission order reducing natural gas rates, the Court held that if the statutory requirement of rates that were "just and reasonable" under section 5(a) of the Natural Gas Act is met, judicial inquiry is at an end. 320 U.S. at 602. The end result, not the method used, controls. Id. The Court re-emphasized that price regulation may, indeed, reduce the value of property regulated. Reduction in value does not mean the regulation is invalid. Id. at 601, citing Block v. Hirsh, 256 U.S. 135, 155-57 (1921), and Nebbia v. New York, 291 U.S. 502, 523-39 (1934). Moreover, setting "'just and reasonable rates' involves a balancing of the investor and consumer interests." 320 U.S. at 603.

As the concurring opinion of

Justices Black, Douglas and Murphy noted in Natural Gas Pipeline, the correct principle was that announced in Covington & Lexington Turnpike Co. v. Sandford:

> It cannot be said that a corporation ... is entitled, as of right, and without reference to the interests of the public, to realize a given percent upon its capital stock.... [Whether] the rates prescribed are unreasonable and unjust to the company and its stockholders ... involves an inquiry as to what is reasonable and just for the public.

164 U.S. 579, 596 (1896) as quoted in Natural Gas Pipeline, 315 U.S. at 607-08. The Natural Gas Pipeline concurrence emphasized that the investor interest is not the only interest to be protected.

> The investor and consumer interests may so collide as to warrant the rate-making body in concluding that a

> return on historical cost or prudent investment though fair to investors would be grossly unfair to the consumers.

315 U.S. at 608.

The consumer interest was given additional emphasis one year after Hope in Market Street Railway Co. v. Railroad Commission, 324 U.S. 548 (1945). The Market Street Railway Company operated street cars and buses in San Francisco. Due to competition from expanding municipally-owned lines, Market Street's traffic and revenue began to decline. The company asked for, and got, in 1939, a fare increase from the area-wide 5 cent standard to 7 cents. 324 U.S. at 555. Except for an increase in traffic during war-time, service continued to deteriorate even with the increased fares. 324 U.S. at 556. The California Supreme Court affirmed an order

of the Railroad Commission of California reducing rates from 7 to 6 cents. 324 U.S. at 552-53. Before this Court, the company claimed the order was confiscatory under Hope because the Commission used a rate base of $7,950,000 (the price at which the company offered to sell its properties to the city). The company challenged the Commission's failure to use reproduction costs (approximately $29,000,000), historical cost, prudent investment, or capitalization bases, and the resultant operating losses to the company. 324 U.S. at 553-54. The return was not sufficient to "'assure confidence in, the financial integrity of the enterprise, so as to maintain its credit and to attract capital'" or to "'enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the

risks assumed.'" 324 U.S. at 566, citing Hope, 320 U.S. at 603. Of Hope, the Court stated that "[a]ll that was held was that a company could not complain if the return which was allowed made it possible for the company to operate successfully." 324 U.S. at 566. Moreover, due process only prevents destruction of value by government action.

> [I]t may be safely generalized that the due process clause has never been held by this Court to require a commission to fix rates on the present reproduction value of something no one would presently want to reproduce, or on the historical valuation of a property whose history and current financial statements showed the value no longer to exist, or on an investment after it has vanished, even if once prudently made, or to maintain the credit of a concern whose securities already are impaired. The due process clause ... has not and cannot be applied to insure values or restore values that have been lost by the operation of economic forces.

324 U.S. at 567 (emphasis added).

Finally, the principles of the due process clause as applied in utility rate-making cases were revisited in Permian Basin Area Rate Cases 390 U.S. 747 (1968), where this Court affirmed the practice of the Federal Power Commission in setting rates for natural gas by the area from which it originated.[12] Reiterating that value may be constitutionally reduced, the Court also recognized that regulation may constitutionally "limit stringently the return recovered on investment, for investors' interests provide only one of the variables in the constitutional calculus of reasonableness." 390 U.S. at 769, again citing Sandford. 164 U.S. 578, 596 (1896). No constitutional objection

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12 As a practical matter, individual rate proceedings involving more than 3300 producers was impossible. At the time of the decision, 570 producers were involved in 3,278 rate increase proceedings awaiting hearing and decision. 390 U.S. at 757 nn. 12, 13.

existed where the commission weighed the interests of individual producers (and their investors) against the consumer interests. 390 U.S. at 770.

This succession of cases illustrates that regulators are allowed wide latitude in determining the particular rates that are "just and reasonable" for any given area at any given time. Indeed, were this not so, utilities would seek review on Fifth Amendment grounds of every rate decision where there was a cost denial. On the contrary, as Hope made apparent, there is no constitutional right to any specific method of determining rates, nor is there any constitutional right to inclusion of any particular cost.

A number of state legislatures have found the inclusion of costs that are not used and useful in rate base to be an

unjust and unreasonable burde.. co place on ratepayers. As noted in Nebbia v. New York, price control is unconstitutional "if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt...." 291 U.S. at 539 The used and useful test is neither arbitrary, discriminatory, nor irrelevant. Nothing in Hope questioned the validity of this criterion for consideration in ratemaking.[13] Rather, that the reverse is true is clear from Market Street. Simply stated, there is no basis in the Constitution for a utility's claim that the cost of cancelled plant must be included in rates.

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[13] See, e.g., Jersey Central Power Co. v. Federal Energy Regulatory Commission, 810 F.2d 1168, 1175 (D.C. Cir. 1987)(en banc) (The used and useful principle is one of several permissible tools of ratemaking); Washington Gas Light Co. v. Baker, 188 F.2d 11 (D.C. Cir. 1950), cert. denied 340 U.S. 952 (1951).

The long-range consequences of allowing this due process attack would be to remove most of the risk from utility investment. The Court would become, in essence, a guarantor of utility investments. This would be especially true if the Court were to disallow the application of the used and useful test.

Moreover, ratepayers are captive; they must purchase a utility's product in order to meet basic needs. Investors are not captive. They may purchase stock in any company and receive the applicable risk premium for successful investments. Investors have been on notice for at least the forty years since Hope that there is no constitutional right to profits and that the consumer interests may outweigh investor interests in any given case. There is no need or reason to change that firmly established principle now.

CONCLUSION

For the reasons stated above, the judgment of the Supreme Court of Pennsylvania should be affirmed.

Respectfully submitted,

STEVEN W. HAMM
Consumer Advocate
South Carolina
Co-Chairman
NASUCA's Electric
Committee

RAYMON E. LARK, JR.*
Ass't Consumer
Advocate
Co-Chairman
NASUCA'S Electric
Committee

National Association
Of State Utility
Consumer Advocates
So. Carolina Depart.
of Consumer Affairs
2801 Devine Street
Post Office Box 5757
Columbia, SC 29250
(803) 734-9464

WILLIAM J. HERRMANN
Chief Counsel for
Illinois Governor's
Office of Consumer
Services
NASUCA Members
SUE A.HERRMANN
NANCY GAITSKILL
of Counsel

Dated June 30, 1988

***Counsel of Record**

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No. 87-1160

IN THE

Supreme Court of the United States

October Term, 1987

DUQUESNE LIGHT COMPANY AND
PENNSYLVANIA POWER COMPANY,
Appellants,

v.

DAVID M. BARASCH, CONSUMER ADVOCATE, *ET AL.*,
Appellees.

On Appeal from the
Supreme Court of Pennsylvania

BRIEF OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS AS *AMICUS CURIAE* IN SUPPORT OF APPELLEES

WILLIAM PAUL RODGERS, JR.
General Counsel
(Counsel of Record)

CHARLES D. GRAY
Assistant General Counsel

National Association of
Regulatory Utility Commissioners
1102 ICC Building
Post Office Box 684
Washington, D.C. 20044
(202) 898-2200

June 30, 1988

Counsel for Amicus Curiae

CASILLAS PRESS, 1717 K STREET, N.W., WASHINGTON, D.C., 20036

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BRIEF OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS AS AMICUS CURIAE IN SUPPORT OF APPELLEES

INTEREST OF AMICUS CURIAE

The National Association of Regulatory Utility Commissioners (NARUC) submits this brief as amicus curiae urging affirmance due to the substantial harm reversal of the decision below may have upon the regulation of public utilities by its member State regulatory commissions. The NARUC files this brief with the written consent of the

Appellants and the Appellees.

The NARUC is a quasi-governmental nonprofit organization founded in 1889. Within its membership are the governmental bodies of the fifty States, and the governmental agencies of the District of Columbia, Puerto Rico, and the Virgin Islands engaged in the regulation of utilities and carriers. The Pennsylvania Public Utility Commission (PUC), an Appellee herein, is a member commission of the NARUC. The mission of the NARUC is to serve the public interest by seeking to improve the quality and effectiveness of public regulation in America.

More specifically, the NARUC contains the State officials charged with the duty of regulating natural gas, electric and communications utility companies operating within their respective borders. As such, these officials have the obligation to assure the establishment and operation of utility companies which serve the public

interest. This means that State commissions, constituted as creatures of their respective legislatures, must seek to ensure that dependable and safe utility service is provided consumers at rates which are just, reasonable and nondiscriminatory.

In the decision on appeal, the Pennsylvania Supreme Court held that a Pennsylvania statute--Act 335 as incorporated into Section 1315 of the Pennsylvania Public Utility Code, 66 Pa. C.S. Sec. 1315--denied Duquesne Light Company and Pennsylvania Power Company (Appellants) the ability to recover their costs in cancelled nuclear power plants from their electric consumers.[1] Appellants have appealed this decision to this Court on the ground that the Pennsylvania

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[1]The decision of the Pennsylvania Supreme Court appears at Appendix A to the Jurisdictional Statement. Subsequent reference will be made to the decision as it appears therein in this form. App. at ___. The case, entitled Barasch v. Pennsylvania Public Utility Commission, is reported at 532 A.2d 325 (Pa. 1987).

Court's construction of Act 335 to deny recovery of plant cancellation costs constitutes a taking of property without compensation and therefore violates the utility ratemaking standards established by this Court in FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944) (Hope) and its progeny.

In support of Appellants, two parties have submitted briefs as amicus curiae supporting reversal and further, urging the Court to make substantial revisions in its Hope jurisprudence. The Edison Electric Institute (EEI), believing that the Pennsylvania Supreme Court relied on "outmoded ratemaking concepts", urges the Court to reconsider the application of the "used and useful" doctrine by regulatory commissions. The Pennsylvania Electric Association (PEA) proposes a more radical transformation of the constitutional requirements of utility ratemaking by urging the Court to hold that regulatory commissions must use the "prudent

investment test as the constitutional benchmark" for utility ratemaking.

If adopted by the Court, the EEI and PEA positions would have a profound impact on the NARUC and its member commissions. Simply put, adoption of these amicus arguments would replace the "end result" test of Hope with this Court's prescription of constitutionally acceptable and unacceptable ratemaking policies and practices. Contrary to the position of amici, Hope has provided regulatory commissions with the flexibility necessary to strike appropriate balances of ratepayer and investor interests in utility-specific cases. Therefore, the NARUC's interest in addressing the EEI and PEA arguments is strong, compelling its participation in the case at bar.

SUMMARY OF ARGUMENT

It is well-settled in the law of regulation that regulatory commissions are obliged by law to regulate public utilities

to ensure that the rates they establish are just and reasonable for both utility investors and consumers. The just and reasonable standard, while codified in the provisions of State and Federal regulatory statutes, has been found by this Court to satisfy the constitutional requirement precluding regulatory commissions from exercising their ratemaking authority in a manner that confiscates utility assets. Permian Basin Area Rate Cases, 390 U.S. 747, 770 (1968), reh. den. 392 U.S. 917 (1968). That is to say, rates found to be "just and reasonable" for statutory purposes do not constitute a taking under the Constitution. Id.

Therefore, the total revenues to be earned by a utility from the sale of its services pursuant to commission-established rate levels are permissible if such revenues fail within the "zone of reasonableness" bounded at the lower end by the constitutional prohibition against confiscation and at the

upper end by the statutory prohibition against the exploitation of utility consumers through the exercise of monopoly pricing powers. Permian Basin Area Rate Cases, 390 U.S. at 770. The phrase "just and reasonableness" is of course general, leaving to regulators the obligation to develop ratemaking methodologies to ensure that the total return a utility earns for providing public service is neither confiscatory or exploitive.

In its decision in FPC v. Hope Natural Gas Co., (Hope), 320 U.S. 591 (1944), this Court determined that the ratemaking methodologies employed by regulatory authorities are not "important" in a constitutional sense if the result of the ratesetting process is a "just and reasonable" rate order. Hope, 320 U.S. at 602-603. By their amicus briefs filed in this case, however, EEI and PEA seek the Court's review of the means by which commissions

establish utility rates whether or not the "end result" of the ratemaking process is within the constitutionally permissible zone of reasonableness. As such, these parties seek not the proper application of the Hope test to Pennsylvania's ratemaking actions; rather, they seek Hope's abandonment by a decision of the Court which describes and defines both constitutionally acceptable and constitutionally suspect ratemaking methodologies.

The invitation to abandon Hope must be rejected. For over forty years, the "end result" test created in that case has proven to be a workable standard enabling regulatory commissions to flexibly and appropriately balance the interests of utility ratepayers and investors. There is no basis for the Court to grant utilities a new constitionally mandated entitlement to their chosen ratemaking methodology. Rather, if the "total effect" of a ratesetting

exercise is not "unjust and unreasonable", the regulatory decision is, and must remain, constitutional. Hope, supra, at 602.

ARGUMENT

In the decision before the Court, the Pennsylvania Supreme Court ruled that Act 335 prohibited the PUC from allowing electric utilities to recover from their ratepayers the costs of plant not "used and useful" in providing electricity. App. at 15a. As a result, utilities subject to Act 335, such as Appellants, were prohibited from including the costs of cancelled nuclear plants in their respective rate bases (thereby denying them a profit from their failed investments) and from recouping cancellation costs as operating expenses through amortization. Id. Appellants contend that the application of the "used and useful" test to deny a return of their cancellation costs constitutes a taking of their property without compensation in violation of Hope.

Amici in support of Appellants urge the Court to go beyond the arguments of Appellants by suggesting that the Court should replace the "end result" test of Hope with a system of judicial review which prescribes the procedures and methodologies regulatory commissions must use to establish utility rates which are "constitutional". Specifically, the Pennsylvania Electric Association (PEA) proposes that the Court require that ratemaking agencies "adopt the prudent investment test ... as the constitutional benchmark." PEA Br. at 21-23. A commission departing from PEA's preferred ratemaking methodology would bear the affirmative burden of justifying the use of any other ratemaking procedures as constitutionally acceptable. Id. at 23. While more circumspect than PEA, the amicus brief of the Edison Electric Institute (EEI) also invites the Court to review the methodologies of the ratemaking process.

While paying lip service to the Hope standard, EEI argues that the "used and useful" concept is constitutionally suspect if a regulatory commission uses original cost rate base valuation methods. EEI Br. at 15-16.

The NARUC submits that these suggestions, which would radically revise the Hope standard applicable to the decisionmaking processes of each of its member commissions must be soundly rejected.

The Court Should Not Adopt A Specific Ratemaking Methodology As The Constitutional "Benchmark"

In Hope, this Court established the standard by which the ratemaking decisions of each regulatory commission--State and Federal--are to be judged:

> It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.

Hope, supra, at 602.
(emphasis supplied)

This language in Hope was presaged in FPC v. Natural Gas Pipeline Co., 315 U.S. 575 (1942) when the Court held that

> The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances. Once a fair hearing has been given, proper findings made and other statutory requirements satisfied, the courts cannot intervene in the absence of a clear showing that the limits of due process have been overstepped. If the Commission's order, as applied to the facts before it and viewed in its entirety, produces no arbitrary result, our inquiry is at an end.
> 315 U.S. at 586.
> (emphasis supplied)

Taken together, Natural Gas Pipeline, supra, and Hope provide regulatory commissions with broad flexibility to use various "formulas or combinations of formulas" to arrive at a utility rate order that is just and reasonable in both a statutory and

constitutional sense.

In turn, the role of courts in reviewing ratemaking orders is limited: (1) to ensuring that the ratemaking agency acted with proper statutory authority; (2) to ensuring that a rate commission's order is reasoned and based upon substantial evidence; and (3) to ensuring that an order, taken as a whole, results in rates that are just and reasonable, i.e. that fall within the zone of reasonableness bounded by the competing interests of investors and the consuming public. Permian Basin Area Rate Cases, 390 U.S. 747, 791-792 (1968). However, in the modern era of this Court's ratemaking jurisprudence that began with Natural Gas Pipeline, this Court has not found that the Constitution demands more of a regulatory commission--as a matter of substance--than that the total effect of a rate order strike a balance between the interests of investors in fair compensation for their

utility investments and the interests of consumers in paying rates free from the abuse of monopoly pricing power.[2]

Therefore, under decisions of this Court, the substance of a ratemaking methodology whether adopted, reconsidered, amended or abandoned by a regulatory commission does not rise to the level of constitutional significance. Wisconsin v. FPC, 373 U.S.

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[2]The Court in Hope, faced with allegations that natural gas rates had been set too low by the Federal Power Commission, not surprisingly devoted its attention to a description of the investor interest in the "financial integrity" of the regulated utility. 320 U.S. at 603. The very purpose of both State and Federal regulation, however, is the protection of utility consumers from exploitation at the hands of a monopoly. Regulatory statutes, such as the Natural Gas Act under consideration in Hope, were enacted "to afford consumers a complete, permanent and effective bond of protection from excessive rates and charges." Atlantic Refining Co. v. Public Service Commission of New York, 360 U.S. 378, 388 (1959). States, acting through regulatory commissions created by their respective legislatures, employ their inherent police powers to protect their citizens under statutes similar in scope and purpose as federal regulatory enactments. Munn v. Illinois, 94 U.S. 113 (1877).

294, 309 (1963). As explained in Permian Basin, supra, the sole substantive inquiry appropriate for a reviewing court is the third ground for judicial review: the assessment of the total effect of a rate order on the competing interest of investors and consumers. 390 U.S. at 792.

PEA would have this Court overrule the Hope standard of constitutional analysis by substituting a single rule of ratemaking--the "prudent investment standard". EEI submits that the application of the "used and useful" doctrine to an original cost rate base is unconstitutional. Both apparently believe that the action of Pennsylvania in this case justifies the abandonment of Hope and the rejection of the multitude of ratemaking practices and procedures established by State and Federal commissions in reliance upon that decision. For at least the following reasons, these amici are wrong.

1. Contrary to the positions of PEA and EEI, the "used and useful" principle employed by the Pennsylvania Court is neither "irrelevant" (PEA Br. at 16), "fundamentally unbalanced" (EEI Br. at 11)[3] nor otherwise constitutionally suspect. Rather, it is one of many ratemaking standards employed by individual ratemaking commissions to calculate a given utility's overall revenue requirement, i.e. the total revenues a utility is given the opportunity to earn in order to recover its costs of service

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[3]In its brief, EEI repeatedly states that "used and useful" has no "constitutional significance" (EEI Br. at 12, n. 14) nor is constitutionally required. While true, these statements seek to confuse the issue. The question is not whether "used and useful" is constitutionally required, but rather, whether the "concept" is constitutionally permissible. Under Hope, "used and useful" is no more or less required or permissible than any other ratemaking methodology used by a ratemaking body. Unlike PEA, which finds Pennsylvania's used and useful per se unconstitutional (PEA Br. at 9-10), EEI concedes that "used and useful" is a "permissible tool of ratemaking". EEI Br. at 12, n. 14, citing Washington Gas Light Co. v. Baker, 188 F.2d 11 (D.C. Cir. 1950).

and compensate its investors. As such, it is of no more consequence in a constitutional sense than the methodology used by a commission to calculate return on equity, allocate the costs of a multistate utility among various jurisdictions, estimate the number of calls connected by a local telephone company, or phase in the cost of an expensive power plant to mitigate precipitous rate increases to consumers. Each of these essentially mathematical calculations must be reasoned and supported by substantial evidence, Permian Basin, supra at 792, but the application of none of these factors--standing alone--directly results in an unconstitutional taking of the property of utility investors. EEI argues that "the 'used and useful' test is not necessarily consistent with the Hope criteria." EEI Br. at 13. A better statement of the law is that standing alone, the "used and useful" test is simply without constitutional importance under the Hope

test.

However, the "used and useful" test serves important regulatory purposes--and not the "generalized ... consumer interest in having lower and more affordable rates (PEA Br. at 20)--which would be lost should the Court abandon the Hope standard in favor of a 'prudent investment' methodology." The test provides regulatory commissions with the power to allocate the inherent risks of the utility business between utility shareholders--who assume investment risks when they purchase stock--and ratepayers who seek nothing but affordable and reliable service. Jersey Central Power & Light Co. v. FERC, 810 F.2d 1168, 1190 n.1 (D.C. Cir. 1987) (Starr, J. concurring) ("The 'used and useful' rule operates as a restraining principle, reminding utility management that they must assume the risk of economic forces working against an investment which is prudent at the time it is made.")

Adoption of the prudent investment test as the "constitutional benchmark" for utility ratemaking would effectively foreclose the ability of regulators to allocate the risks of plant failure between shareholders and ratepayers. As Judge Starr ably described in Jersey Central, supra, the prudent investment rule shifts the risks of construction--including the risk of bad management--to ratepayers thereby effectively insulating the utility and its investors from the vicissitudes of the market. 810 F.2d at 1190-91. Moreover, the test proposed by amici would require that ratepayers pay for investments providing them "no discernible benefit." Id.

In fact, beyond the issue of risk allocation, the "used and useful" test serves the entirely appropriate and important public purpose of ensuring that ratepayers not support financially utility investments having nothing to do with utility service.

Utilities may invest in nonregulated subsidiaries operating computer companies, baseball teams or cable television systems and under a prudent investment standard, charge ratepayers for their investments on the grounds that it is "prudent" for a utility to diversify its businesses in a volatile economy. On a more mundane level, a prudent investment test might well guarantee a utility the right to recover from ratepayers the costs of promotional advertising, political or charitable contributions, country club dues and the like.[4]

In sum, the used and useful test is a valuable and legitimate regulatory tool which is neither unconstitutional per se

[4]There is a certain irony here in that amici advocate a constitutional ratemaking test which would require the recovery of utility costs which the Congress has determined should not be charged to ratepayers. See Section 113(b)(5) of the Public Utility Regulatory Policies Act of 1978, codified at 16 U.S.C. Sec. 2623(b)(5) (1985) (denying ratepayer support for "promotional or political advertising"); FERC v. Mississippi, 456 U.S. 742 (1982).

nor when applied to achieve a just and reasonable end result. Hope, supra.

2. The NARUC submits that this case is clearly an inappropriate vehicle for the Court to jettison Hope in favor of a new prudent investment standard having Nationwide application.[5] Simply put, neither Appellant utility companies nor their supporting amici have shown or alleged that the decision

[5]While the facts of this case involve the question of cost recovery for cancelled plants, a prudent investment test as advocated by amici would apply to all investments of all types of utilities. It is for this reason that the NARUC is deeply concerned about the implications of amici's farreaching arguments which would place a constitutional straitjacket on each NARUC member commission. Under Hope, regulatory commissions use a variety of procedures and methodologies to discharge their responsibility to protect the public interest. For example, on the cancelled plant issue, State commissions have developed a broad spectrum of policies and procedures to allocate the risks and burdens of failed utility investments. See Rodgers and Gray, State Commission Treatment of Nuclear Plant Cancellation Costs, 13 Hofstra L.R. 443 (1985) and cases therein cited. See also Drubak, From Turnpike to Nuclear Power: The Constitutional Limits on Utility Rate Regulation, 65 B.U.L.R. 65, 112-119 (1985).

of the Pennsylvania Court creates any financial distress or has otherwise taken the value of any of their shareholders' investments. Indeed, as the Pennsylvania Public Utility Commission recounts in its brief as Appellee, the decision of the Pennsylvania Court will have a "total effect" of less than 1 per cent on Appellants' overall revenues when applied to the underlying rate order of the State commission. Br. of PUC at 35.[6] Given these facts, Appellants have not shown that their respective rate levels have fallen below the "zone of reasonableness" described in Natural Gas Pipeline, supra, 315 U.S. at 585-586. Nor have they shown that the Pennsylvania

[6]In Jersey Central Power & Light, supra, the utility was able to allege financial distress sufficient to entitle it to a hearing on its taking claim, but not necessarily any recovery of its cancelled plant costs. 810 F.2d at 1170-71. Until Jersey Central provided factual proof of confiscation under the "consequences of the rate order" the Court had no basis to order a profit on the disputed costs. Id. at 1181.

Court's decision has improperly denied them sufficient revenues "for operating expenses but also the capital costs of business." Hope, supra, 320 U.S. at 603.

Therefore, there is simply no need for the Court to adopt a new ratemaking standard through its decision in this case. Contrary to EEI's unsubstantiated assertions (EEI Br. at 13-14), there is no imminent financial crisis in the electric utility industry caused by a failure of regulatory commissions to conscientiously discharge their responsibilities. There is clearly no warrant for this Court to require a ratemaking standard "weighted in favor of the utility"[7] to be applied by all State and Federal regulators for all utilities.

3. Finally, this Court's creation of a constitutional "benchmark" for utility rate regulation will not, as PEA suggests,

[7]Jersey Central Power & Light, supra, at 1190.

"protect this Court's docket from the burden of reviewing the details of a plethora of rate decisions". PEA Br. at 23.[8] Rather, a decision of the Court which creates constitutional standards for assessing individual ratemaking methodologies will only increase the burden on this and other courts. First of all, if the prudent investment standard is the "constitutional benchmark", every departure by a regulatory commission will be a constitutional question for reviewing courts to decide. Moreover, such litigation will not be limited to the overall effect of a rate order as is now the law under Hope;[9] rather, utilities will be able to seek judicial review of discrete determinations--such as the calculation of

[8]PEA's proposes that commissions bear the burden of "affirmatively demonstrating" the validity of other non-favored ratemaking mechanisms. PEA Br. at 23. Of course, under standard regulatory practice, a utility seeking increased revenues bears the burden of proof on each relevant issue.

[9]Permian Basin, supra, 390 U.S. at 792.

rate base--regardless of their financial health or their overall earnings. Further, we do not understand PEA to argue that the "total effect" of a rate order would be unreviewable even if the commission issuing the order faithfully applying the prudent investment standard. Therefore, utilities would have more, rather than fewer, issues to take to court.

Second, adoption of a prudent investment rule could only increase the number of ratemaking cases in which management prudence--an exceedingly complex inquiry--is at issue. Inevitably, parties seeking relief from high utility rates would aggressively litigate the prudence question--their only real alternative under PEA's proposed ratemaking test--thereby burdening courts and commissions with issues whose outcome would have no real bearing on the financial welfare of investors.

Third, a decision of the Court creating

a prudent investment standard for rate base valuation would without doubt open the flood gates for litigation of the "constitutionality" of other ratemaking mechanisms. Perhaps the next case to come before the Court would involve a utility's suggestion that the discounted cash flow method of calculating return on equity is the only constitutionally permissible standard. Or the next appellant may argue that the Constitution requires that utility property with a useful life of five years or less be expensed rather than capitalized. The point here is that once the Court starts down the path of deciding what are acceptable and unacceptable ratemaking methodologies, such items as regulatory accounting standards, operating expense calculations, indeed the very details of ratemaking, become subject to constitutional scrutiny in the State and Federal courts.

In sum, by seeking to raise a discrete

ratemaking calculation to independent constitutional significance, Appellants and their amici would engraft a new substantive due process jurisprudence on utility ratemaking to stand along side the objective Hope standard. By so doing, these parties would create more litigation, more confusion, and direct involvement of the courts in the ratesetting process. The NARUC respectfully submits that such an outcome is clearly unwarranted in the context of this proceeding. The Hope standard has served the public interest well. It should not be discarded, abridged or revised.

CONCLUSION

This Court should affirm the judgment below.

Respectfully submitted,

WILLIAM PAUL RODGERS, JR.
General Counsel
(Counsel of Record)

CHARLES D. GRAY
Deputy Assistant General Counsel

National Association of
Regulatory Utility Commissioners
1102 ICC Building
Post Office Box 684
Washington, D.C. 20044
(202) 898-2200

Attorneys for Amicus Curiae

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ROBERT L. BEZEK, JR.
ANDERSON, BYRD & RICHESON
Second & Main, P.O. Box 7
Ottawa, KS 66067
(913) 242-1234

BRIAN J. MOLINE
712 S. Kansas Avenue
Suite 201
Topeka, KS 66603
(913) 354-8531
Of Counsel

BENNA RUTH SOLOMON *
Chief Counsel
JOYCE HOLMES BENJAMIN
BEATE BLOCH
STATE AND LOCAL
LEGAL CENTER
444 N. Capitol Street, N.W.
Suite 349
Washington, D.C. 20001
(202) 638-1445

* *Counsel of Record for the* Amici Curiae

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QUESTION PRESENTED

Whether the Takings Clause precludes a State, in setting utility rates, from implementing its policy of permitting reimbursement only of investment that is used and useful in the public service by denying recovery of costs incurred in planning cancelled nuclear plants.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

No. 87-1160

DUQUESNE LIGHT COMPANY

AND

PENNSYLVANIA POWER COMPANY,
Appellants,

v.

DAVID M. BARASCH,
CONSUMER ADVOCATE, *et al.*,
Appellees.

On Appeal from the Supreme Court of Pennsylvania

BRIEF OF THE NATIONAL GOVERNORS' ASSOCIATION, U.S. CONFERENCE OF MAYORS, INTERNATIONAL CITY MANAGEMENT ASSOCIATION, NATIONAL ASSOCIATION OF COUNTIES, AND NATIONAL LEAGUE OF CITIES AS *AMICI CURIAE* IN SUPPORT OF APPELLEES

INTEREST OF THE *AMICI CURIAE*

The *amici*, organizations whose members include state, county, and municipal governments and officials throughout the United States, have a compelling interest in legal issues that affect state and local governments. This case concerns electric utility ratemaking, "one of the most important of the functions traditionally associated with the police power of the States." *Arkansas Electric Cooperative Corp. v. Arkansas Public Service Comm'n*, 461 U.S. 375, 377 (1983). Indeed, the States are responsible for 90% of the utility regulation in this coun-

try.[1] Moreover, many state and local governments and agencies are captive customers of intrastate utility monopolies.

The case arises from the cancellation of four proposed nuclear plants. Appellants were denied recovery of pre-construction planning expenses for the plants under a Pennsylvania statute that prohibits electric utilities from charging the cost of constructing or expanding their facilities to the ratepayers until "such time as the facility is used and useful in service to the public." Appellants contend that this denial effected an uncompensated taking of their property in violation of the Fifth and Fourteenth Amendments. The statute codifies Pennsylvania's longstanding ratemaking policy, similar to that in many other States, that an electric utility may not include in its rates the cost of construction work in progress until the project has been placed in public service.

Amici fear that the invalidation of this policy would strip the States of an important, time-tested regulatory tool. Such a decision could force the public to assume the cost of virtually all utility expenditures, no matter how superfluous, absolving investors of any risk of loss from the consequences of mistakes by management. Moreover, this Court would become the ultimate arbiter of ratemaking disputes, indeed the ultimate ratemaker, by sitting in review of every disallowance of every utility expense.

An electric utility company is a natural monopoly subject to regulation, but it operates as a for-profit enterprise, receiving many state-conferred benefits in exchange for providing power to the public. The right of the utility to a fair return is generally recognized to avoid what would be tantamount to confiscation of property that is used to serve the public. In this case, the utilities have not been forced to operate any property

[1] *See Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168, 1207 (D.C. Cir. 1987) (en banc) (Mikva, J., dissenting).

in the public interest. Their expenditures for the proposed plants produced no benefit for ratepayers or for the Commonwealth because management cancelled the plants at the initial stage of planning. This Court has never suggested, much less held, that the Constitution requires reimbursement of all utility expenditures unless they are shown to be imprudent.

Amici are concerned that appellants' claims would significantly expand the takings doctrine as applied to utility rate regulation. Their contentions are radical departures from settled law and would hamstring the States in their regulatory capacity by preempting their judgment how best to balance the public interest with that of investors in regulating rates for electricity and other public services. *Amici* submit that the decision of the Pennsylvania Supreme Court is correct. Because this Court's decision will have a direct effect on matters of prime importance to *amici* and their members, *amici* submit this brief to assist the Court in its resolution of the case.[2]

STATEMENT

Amici believe that an understanding of the facts of this case is aided by a review of the method normally employed by utility regulatory commissions. State and federal regulators use a standard formula to determine the total revenues that a utility may raise through rates.[3] The formula is designed to cover legitimate operating expenses and to allow a return on the utility's rate base. Operating expenses are the current costs associated with furnishing utility service, and typically include

[2] The parties' letters of consent pursuant to Rule 36 of the Rules of the Court have been filed with the Clerk.

[3] The revenue formula may be expressed as $R = O + (V - D)r$. R is the total revenue required; O is the operating costs; $(V - D)$ is the net value of or investment in the rate base, with V representing the gross value of the tangible and intangible property and D the accrued depreciation of the tangible and reproducible property; and r is the allowed rate of return. See C. Phillips, Jr., *The Regulation of Public Utilities* 157-58 (1984).

wages, salaries, fuel, maintenance, taxes, and annual depreciation.[4]

The rate base is "the value of a utility's property used and useful in the public service minus accrued depreciation" (Phillips, *supra* n.3, at 281). It is helpful to distinguish between "the elements of value" and "the measures of value." *Id.* at 282. The elements of value may be classified in four categories: tangibles, including "'used and useful' land, buildings, and equipment (plant)"; working capital, property held for future use, and intangibles, including leaseholds and water rights; customer contributions and tax deferrals; and construction work in progress. *Ibid;* see also *id.* at 159. Not all States allow all elements to be included.[5] The measures of value, typically fair value or prudent investment, also vary from State to State.[6]

The rate base is multiplied by the rate of return to yield the net earnings, over and above operating ex-

[4] See *id.* at 158. A utility may charge other items, such as advertising, research and development, charitable contributions, and purchases from affiliated subsidiaries, to operating expenses, but these may not be fully allowed for ratemaking purposes. See *ibid.* "When an expenditure is disallowed it, in effect, is charged to a utility's stockholders rather than to its customers." *Ibid.*

[5] *Id.* at 159, 282. For example, in some jurisdictions (although not in Pennsylvania), construction work in progress is included in the rate base. See *id.* at 158-59. In jurisdictions where it is excluded, the allowance for funds used during construction is capitalized until the project is complete. See *id.* at 159. Other common exclusions are customer contributions and tax deferrals (*id.* at 282) and certain intangibles, such as franchise value, going concern value, and good will. *Id.* at 159.

[6] A recent survey of practices among regulatory commissions found that thirty-eight States and the District of Columbia use original cost or prudent investment; eleven use fair value or current value; and three consider all evidence submitted. See *id.* at 308, citing National Association of Regulatory Utility Commissioners, *1981 Annual Report on Utility and Carrier Regulation* 430-31 (1982). With one minor exception, the federal government uses original cost. See *id.* at 308 & n.80.

penses (including taxes) and depreciation. The allowed percentage is a weighted composite of the rates required to pay the interest on bonded indebtedness, dividends to preferred stockholders, and a return on the investment of common stockholders.[7]

This case grew out of two ratemaking proceedings before the Pennsylvania Public Utility Commission (PUC). In 1973, Duquesne Light Company (Duquesne) and Pennsylvania Power Company (Penn Power), as part of an interstate group of electric utility companies, decided to construct seven nuclear plants to meet the anticipated needs for electric power in Western Pennsylvania and Ohio. J.S. App. 2a-3a, 7a. Pennsylvania did not require the utilities to obtain prior PUC approval of the proposed construction; and they neither sought nor received approval of their decision to build.[8] Because Pennsylvania does not recognize construction work in progress as an operating expense, appellants planned to capitalize their costs for inclusion in the rate base once construction was complete.

[7] Each of these components yields a different rate. See *id.* at 331-32. The "equity" rate includes a "risk premium" in addition to the cost of risk-free investment, both arrived at on the basis of market factors. See, *e.g.*, J.S. App. 91c-93c; 46e-48e.

[8] In proceedings before the PUC to investigate the delays in the construction of the plants at issue here, appellants resisted the Commission's jurisdiction "[a]s to the propriety of construction and selection of fuel . . . ." J.S. App. 7h. This argument was based on findings of an administrative law judge that the Commission lacked jurisdiction over the planning and siting of electric generating units, that a utility may plan and construct without the express approval of the Commission, and that the first time that a utility must seek approval was in a rate proceeding subsequent to placing the unit in service. See *ibid.*

Most state commissions do not have the power to approve construction in advance. See Pierce, *The Regulatory Treatment of Mistakes in Retrospect: Canceled Plants and Excess Capacity*, 132 U. Pa. L. Rev. 497, 508, 532 (1984). "The decision to begin construction of a new generating plant is the utility's, at least in the first instance." *Id.* at 508.

In 1980, before obtaining a construction permit from the Nuclear Regulatory Commission, the utilities decided to cancel construction of four of the proposed nuclear plants. J.S. 4.[9] The PUC did not order the cancellation, and the utilities neither sought nor received approval of their decision to cancel construction.[10] Duquesne's share of the "pre-construction" costs amounted to $34,697,389 (J.S. App. 3a); Penn Power's equaled $9,569,665. *Id.* at 7a. In ratemaking proceedings before the PUC seeking a general increase in rates, the two utilities sought to amortize these pre-construction costs, as part of their operating expenses. *Id.* at 3a, 7a.

While the Duquesne rate case was before the PUC, the Pennsylvania Legislature amended the Public Utility Code by Act 1982-335, 66 Pa. Cons. Stat. § 1315, to provide that the "cost of construction or expansion of a facility" could not be "made a part of the rate base nor otherwise included in the rates charged by the electric utility" until the plant was "used and useful in service," which was defined as "presently providing actual utility service to the customers." *Id.* at 4a-5a.

The Administrative Law Judge (ALJ) appointed by the PUC to investigate the plant construction program, found that the utilities had acted prudently at relevant stages of the pre-construction period; he recommended that Duquesne be allowed to recover the cost of the planning for the cancelled plants by amortization over a period of ten years at the rate of $3,469,739 a year. *Id.*

[9] The project was owned primarily by three Ohio utilities, which were denied recovery of their share of the costs. *See Office of Consumers' Counsel v. PUC*, 67 Ohio St. 2d 153, 423 N.E.2d 820 (1981), *appeal dismissed*, 455 U.S. 914 (1982); *Cleveland Elec. Illum. Co. v. PUC*, No. 82-165 (Ohio, July 7, 1982), *appeal dismissed*, 459 U.S. 1094 (1983); *Cleveland Elec. Illum. Co. v. PUC*, 4 Ohio St. 3d 107, 447 N.E.2d 746, *appeal dismissed*, 464 U.S. 802 (1983).

[10] "The decision to cancel a partially constructed plant . . . is also the utility's in the first instance." Pierce, *supra* n.8, at 510. It appears that even fewer States can order cancellation than can approve construction. See *ibid.*

at 4a. The PUC accepted the ALJ's report; it also interpreted Section 1315 to bar adding the costs of incomplete construction to the rate base, but not to preclude passing through those costs to the ratepayers by amortization. *Id.* at 5a-6a. The PUC granted Duquesne an overall annual revenue allowance of $802,463,063, an increase of $105,850,000 (*id.* at 126c), or 15.2%. The amortization at issue in this case thus constitutes 3.28% of the annual increase allowed by the PUC and less than ½ of 1% (.43%) of Duquesne's total annual revenue allowance. The increased revenue allowance reflected an equity return of 16.14% and an overall return of 11.64%. *Id.* at 93c.

In a separate proceeding, the PUC, relying on the ALJ's report and its own decision in the Duquesne rate case, allowed Penn Power to amortize its pre-construction costs at the rate of $956,967 for ten years. *Id.* at 7a. The PUC granted Penn Power overall revenues of $184,186,000, an increase of $15,364,000 (*id.* at 3e-4e), or 9.1%. The amortization contested here thus constitutes 6.2% of the revenue increase approved by the PUC and slightly more than ½ of 1% (.52%) of Penn Power's total annual revenue allowance. The increased revenue allowance reflected an equity return of 15.72% and an overall return of 12.02%. *Id.* at 48e.

The Office of Consumer Advocate filed petitions with the Commonwealth Court for review of the orders in both the Duquesne and Penn Power proceedings, which were consolidated on appeal. *Id.* at 8a. The Commonwealth Court held, in a four-to-three decision, that the PUC had correctly construed Section 1315. *Id.* at 8a-9a. On appeal, the Pennsylvania Supreme Court unanimously reversed on the ground that Section 1315 precluded recovery of the pre-construction expense of the cancelled plants. *Id.* at 15a. The court rejected appellants' federal constitutional challenges[11] and remanded

[11] The court rejected appellants' argument that such an interpretation would "wor[k] a confiscation of utility property without

the case to the PUC for further proceedings. *Id.* at 30a-31a.

SUMMARY OF ARGUMENT

I. Appellants' assertions of per se taking reflect a misunderstanding of this Court's decisions in the field of utility rate regulation. The criticisms voiced by Justice Brandeis, concurring in *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Comm'n*, 262 U.S. 276, 289 (1923), persuaded the Court to repudiate the requirement that a utility receive a fair return on the "fair value" of its property devoted to the public service (*see Smyth v. Ames*, 169 U.S. 466 (1898)). When it did so, however, the Court shifted its focus from the details of the ratemaking process to its end result. Thus, in *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942), the Court approved a reduction in natural gas rates, finding that the rate order, "viewed in its entirety, produce[d] no arbitrary result." In *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944), the Court clarified that judicial review was confined to "the total effect of the rate order," regardless of "infirmities" in "the method employed to reach that result." Since then, the Court has repeatedly declined to mandate either a particular methodology or a particular rate, and has required only that the end result avoid confiscation.

Appellants' reliance on Justice Brandeis' *Southwestern Bell* concurrence as replacing the used and useful test by the prudent investment standard errs on two grounds. First, that standard refers only to the measure of value of property, and not to the inclusion of elements of value in the rate base. For the latter purpose, Justice Brandeis supported the used and useful test. Second, although the Court agreed with Justice Brandeis that the "fair value" standard must be rejected, it did not adopt his prudent investment standard. The Court has wisely refused to mandate any single standard for utility regulators. Prudent investment, in particular, is seriously flawed as an exclusive determinant of utility rates.

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just compensation." J.S. App. at 21a. The court also rejected Duquesne's claim that Section 1315 violated the Due Process Clause by operating retroactively, finding no contractual or vested right to recover the cost of investments that do not provide utility service. *Id.* at 26a. Finally, the court rejected an equal protection claim (*id.* at 27a-30a) and claims under the state constitution.

Appellants' asserted rights to a balancing in their favor of investor and consumer interests rests upon references in *Hope* and the *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), to the investor interests that the ratemaking process should consider. In neither *Hope* nor *Permian*, however, did the Court engage in balancing; in both cases, the Court concluded its inquiry when it determined that the investor interest had been met by the establishment of nonconfiscatory rates. Here, appellants have not even alleged that their overall revenue allowance is confiscatory. Moreover, investor interests are only part of the equation; and on this record there is no reason to elevate them over those of the ratepayers and the public.

II. Appellants' per se arguments find even less support in regulatory takings cases outside the utility context. There is no physical invasion of property, nor even any physical property to invade. The facts do not meet the criteria used by the Court to evaluate regulatory takings. The overall economic impact on appellants of denying recovery of their cancellation costs is minimal, especially when compared with losses in other unsuccessful takings claims. *See, e.g., Hadacheck v. Sebastian*, 239 U.S. 394 (1915). These costs may not be isolated for takings law purposes as separate segments of property. *Keystone Bituminous Coal Ass'n v. DeBenedictis*, 107 S.Ct. 1232, 1249 (1987). Nor have appellants, whose arguments depend on a world in which utility investments are risk-free, shown *reasonable* "investment-backed expectations" of recovery of the cost of the cancelled plants (*see, e.g., Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979)). Finally, appellants have not identified any governmental action that took anything from them. It was not the Commonwealth of Pennsylvania but economic forces that rendered their investment worthless.

ARGUMENT

Constitutional protection for utilities in rate regulation is based on the right to a fair return on property put to public use, namely to provide utility service.[12] The theories used by this Court in reviewing the constitutionality of rate regulation have varied over time, but today there can be no doubt that the appropriate standard is whether the rate arrived at can be termed confiscatory, without regard to the methodology employed.[13]

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[12] *See Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168, 1175 (D.C. Cir. 1987) (en banc); *see also FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 602-03 (1942) (Black, J., concurring); see generally Drobak, *From Turnpike to Nuclear Power: The Constitutional Limits on Utility Rate Regulation*, 65 B.U.L. Rev. 65, 72-79 (1985).

[13] Over time, the Court has identified both the Takings Clause (*see, e.g., Smyth v. Ames*, 169 U.S. 466, 546 (1898) ("just compensation" for the use of property beneficial to the public required), and the Due Process Clause (*see, e.g., Denver Union Stock Yard Co. v. United States*, 304 U.S. 470, 475 (1938); *Natural Gas Pipeline*, 315 U.S. at 586; *see also id.* at 599 (Black, J., concurring)), as the source of the constitutional limits on rate regulation.

More recently, the Court has not explicitly named the source of the constitutional protection. *See, e.g., FPC v. Texaco Inc.*, 417 U.S. 380, 391-92 (1974) (referring only to "constitutional" limitations on ratemaking); *Permian Basin Area Rate Cases*, 390 U.S. 747, 768-70 (1968) (same). In *FCC v. Florida Power Corp.*, 107 S. Ct. 1107, 1113 (1987), the Court cited "traditional Fifth Amendment standards," but discussed only a taking of "private property devoted to public uses." *See also id.* at 1114 (Powell, J., concurring).

In *Pennell v. City of San Jose*, 108 S. Ct. 849 (1988), involving the related issue of rent control, the Court considered both takings and due process challenges to a requirement that tenant hardship be considered in reviewing a substantial rent increase. The majority held that the takings claim was premature (*id.* at 856), but two Justices dissented, finding that a taking had occurred (*id.* at 859). The Court, however, did reach, and rejected without dissent, the due process claim. *Id.* at 858, 859.

In this case, the questions presented are phrased in terms of takings, and appellants do no more than hint at a violation of substantive due process (Brief at 24 n.20). Although this case therefore does not require the Court to decide what difference there may be between due process and takings standards in the context of utility rate regulation, *amici* suggest that the modern view of the constitutional restrictions on rate regulation is probably better grounded in takings law. By setting rates, the government intends to allow compensation. Even if, in a particular case, the overall revenue provides insufficient compensation, the intention to pay for the public's use of utility property is still present. The Court has relied on notions of substantive due process to determine when regulation that the government does not intend to pay for "goes too far." *See Nollan v. California Coastal Comm'n*, 107 S. Ct. 3141, 3150 (1987); *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393, 415 (1922). Moreover, in its modern application, substantive due process has little force to invalidate rate regulation. "The standard for determining whether a state price-control regulation is constitutional under the Due Process Clause is well established: 'Price control is "unconstitutional . . . if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt. . . ."'" *Pennell*, 108 S. Ct. at 857 (quoting *Permian*, 390 U.S. at 769-70, quoting *Nebbia v. New York*, 291 U.S. 502, 539 (1934)).

Given the formula by which a revenue allowance is determined (see pp. 3-5, *supra*), in a particular case challenges may be leveled at exclusions from the rate base, undervaluation of property in the rate base, a low rate of return, or—as in this case—the exclusion of operating costs or other annual expenses. This Court's cases have reflected considerable controversy over what property should be included in the rate base,[14] how it should be valued,[15] and the appropriate rate of return on that value.[16]

The present case, however, raises only the question whether appellants' pre-construction expenses incurred in the initial planning stages of their ill-fated nuclear venture must be included in their revenue allowances as operating

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[14] *See, e.g., FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 605-06 (1944); *Denver Union Stock Yard*, 304 U.S. at 475-77.

[15] *Compare Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 290 (1923) (Brandeis, J., concurring), *with Smyth v. Ames*, 169 U.S. at 546-47.

[16] *See, e.g., Permian*, 390 U.S. at 768-70; *Hope*, 320 U.S. at 604-05; *Natural Gas Pipeline*, 315 U.S. at 584-86.

expenses.[17] This Court has resolved comparatively few disputes between utilities and their regulatory commissions over the legitimacy of operating expenses, and appellants cite none in the modern era since *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

Instead, appellants and their *amici* assert in a variety of ways that Pennsylvania's refusal to permit recovery of these expenses constitutes a per se taking. These claims stand in sharp contrast to this Court's decisions, which make clear that per se takings are extremely rare. In the utility context, the modern cases exemplify a highly deferential standard based on the overall revenue allowance, which, if reasonable, will be sustained without descending into the particulars. *See Hope*, 320 U.S. at 602; *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942). In other contexts, the Court has repeatedly emphasized that the takings analysis rests on an ad hoc, factual inquiry. *See, e.g., Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979); *Penn Central Transportation Co. v. New York City*, 438 U.S. 104, 124 (1978). Under either approach, no taking, per se or otherwise, has been shown on this record.

I. DENIAL OF RECOVERY FOR PROPERTY THAT IS NOT "USED AND USEFUL" DOES NOT EFFECT A TAKING UNDER TRADITIONAL RATE REGULATION CONCEPTS.

Appellants rely on this Court's seminal cases on utility rate regulation to attack the decision below. Because appellants' discussion of these cases seriously misconstrues their teachings, we review them briefly before turning to appellants' specific contentions.

[17] Appellants argued in the Pennsylvania Supreme Court (Brief of Duquesne below at 13, 18, 56; Brief of Penn Power below at 11, 38, 46, 47) and they still argue (Brief at 30 n.23) that they are entitled to recover these expenditures as operating expenses. We use this term even though the expenses are not those typically classified as operating expenses, *i.e.*, expenses of operating the utility to produce electricity. See n.4, *supra*.

An historical review. For many years, the controlling authority on questions of rate base and rate of return was *Smyth v. Ames*, 169 U.S. 466 (1898), which held that a utility was entitled to a "fair return" on the "fair value of the property being used by it for the convenience of the public." *Id.* at 546-47. The Court's later abandonment of the "fair value" standard is generally traced to Justice Brandeis's concurring opinion in *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Comm'n*, 262 U.S. 276, 289 (1923). In its move away from the "fair value" standard, the Court did not, however, adopt the "prudent investment" standard advocated by Justice Brandeis in *Southwestern Bell*. Instead, the Court shifted its focus in reviewing utility rate regulation from the ingredients of the ratemaking process to the bottom line.

The shift began with *Natural Gas Pipeline*, a challenge to the constitutionality of the Natural Gas Act of 1938, 52 Stat. 821, 15 U.S.C. § 717 *et seq.* The Court upheld the Act's standard of "just and reasonable rates" as identical with the constitutional standard; thus the FPC could order a decrease where existing rates were not the "lowest reasonable rates." 315 U.S. at 586. In approving a rate reduction ordered by the FPC, the Court held (*ibid.*; emphasis added):

> The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances. . . . If the Commission's order, as applied to the facts before it and *viewed in its entirety*, produces no arbitrary result, our inquiry is at an end.

Within two years, the Court would clarify that the "entirety" of the order was to be measured by the "end result"; and the fair value standard would become just one of the methodologies available to reach that end re-

sult. In *Hope*, the Court reaffirmed the conclusions reached in *Natural Gas Pipeline*, holding (320 U.S. at 602):

> It is not the theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry . . . is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.

Parallel reasoning led the Court to reject the contention that there is but one constitutional rate. Rather, rate regulation reflects a "broad zone of reasonableness," and any rate falling within that zone "cannot properly be attacked as confiscatory." *Permian Basin Area Rate Cases*, 390 U.S. 747, 770 (1968). When the Court dismissed for the second time the argument that there is only one just and reasonable rate, it specifically rejected a rate "based entirely on some concept of cost plus a reasonable rate of return." *Mobil Oil Corp. v. FPC*, 417 U.S. 283, 316 (1974). In the Court's most recent case deciding a takings challenge to rate regulation, the Court held simply that "[s]o long as the rates set are not confiscatory, the Fifth Amendment does not bar their imposition." *FCC v. Florida Power Corp.*, 107 S. Ct. 1107, 1113 (1987).[18]

Although *Hope* and *Permian* did not deal with operating expenses, they did prescribe the constitutional standard for judging the sufficiency of all revenue allowances, whether the shortfall is attributed to elements

[18] *See also FPC v. Texaco Inc.*, 417 U.S. 380, 391-92 (1974) ("All that is protected against, in a constitutional sense, is that the rates fixed . . . be higher than a confiscatory level."); *id.* at 392 ("whether any rate is confiscatory . . . can only be judged by 'the result reached, not the method employed' ", citing *Hope*, 320 U.S. at 602); *Baltimore & O.R.R. v. United States*, 345 U.S. 146, 148 (1953) ("So long as a railroad is not caused by such regulations to lose money on its over-all business, it is hard to think that it could successfully charge that its property was being taken for public use 'without just compensation.' ").

or measures of value in the rate base, to the rate of return, or to operating expenses.[19] That constitutional standard does not, however, as appellants insist (Brief at 19, 26-33), reject the used and useful test or mandate recovery of all prudent investment.

Given *Hope*'s holding that the Constitution does not require regulators to use any particular methodology, nothing is inconsistent with *Hope* except an insistence on a single methodology. Similarly, given *Permian*'s holding that the Constitution does not require any single rate, nothing is inconsistent with *Permian* except an insistence on a particular rate. *Hope* and *Permian* embrace a choice of methodology, and a zone of reasonable rates; they preclude nothing except a confiscatory bottom line.[20] In this case, of course, appellants have not even alleged that their overall revenue allowances are confiscatory.[21]

[19] Thus, if the exclusion of an item of operating expenses were significant enough to render the overall revenue allowance confiscatory, *Hope* and *Permian* suggest that the bottom line might have to be adjusted to a constitutionally sufficient level. Consistent with *Hope* and *Permian*, however, a reviewing court should not mandate any particular remedial approach. Operating costs or elements of the rate base that have been properly excluded by application of general principles should not be ordered back in; nor should a rate base properly valued according to standard practices be ordered revalued. *See, e.g., Jersey Central*, 810 F.2d at 1188 (authorizing FERC to choose either option or to adjust the rate of return).

[20] The D.C. Circuit has expressly rejected the contention that the used and useful test may not constitutionally be applied. *See Jersey Central*, 810 F.2d at 1187 ("The Commission is not precluded from employing 'used and useful,' or any other specific rate-setting formula"); *id.* at 1188 ("Jersey Central has mounted an ill-conceived and overly broad attack on the 'used and useful' principle") (Starr, J., concurring).

[21] Such a claim would border on the frivolous. The exclusions amounted to approximately ½ of 1% of appellants' annual revenue allowances, and their annual increases, even after the exclusions, were 14.75% for Duquesne, and 8.5% for Penn Power. In its Form 10-K filing with the Securities and Exchange Commission, for the fiscal year ending December 31, 1986, Duquesne concluded (at 15)

Rather than meet the requirements of *Hope* and *Permian* by demonstrating deficiencies of constitutional proportion in their revenue allowances, appellants urge upon this Court the startling propositions that the used and useful standard cannot be employed, that the prudent investment standard must be employed, and that any exclusion of operating expenses fails to take proper account of investors' interests.

The used and useful standard. Appellants trace their condemnation of the used and useful standard to Justice Brandeis' concurring opinion in *Southwestern Bell.* In this attempt, they fail to distinguish between what Justice Brandeis advocated and what he achieved. He clearly advocated abandoning the fair value standard; and the Court ultimately agreed. *See Hope*, 320 U.S. at 601, 605. He also advocated replacing the fair value standard with a standard of prudent investment; but in this he was not successful. *See id.* at 605-06; *see also Natural Gas Pipeline*, 315 U.S. at 606 (Black, J., concurring).[22]

Moreover, appellants' argument confuses the elements of value in the rate base and the measures of value of those elements. As a result, appellants attribute to Justice Brandeis a view that he did not advocate. The prudent investment standard is used as a measure of value of

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that the case before the Pennsylvania Supreme Court "will not have a material adverse effect on its financial position or results of operations."

[22] Even Justice Jackson, dissenting in *Hope*, agreed that the Court had not adopted the prudent investment standard.

> The Commission appears to have understood the effect of the two opinions in the *Pipeline* case to be at least authority and perhaps direction to fix natural gas rates by exclusive application of the "prudent investment" rate base theory. This has no warrant in the opinion of the Chief Justice for the Court, however, which released the Commission from subservience to "any single formula or combination of formulas" provided its order, "viewed in its entirety, produces no arbitrary result."

320 U.S. at 628, quoting *Natural Gas Pipeline*, 315 U.S. at 586.

elements in the rate base; it is not used to identify the elements that should be included in the rate base (see p. 4, *supra*). Justice Brandeis preferred prudent investment to fair value as the measure of value; he did not advocate any change in the used and useful standard, which identifies the elements of value to be included in the rate base.[23] Thus, the prudent investment standard, even if the Court had adopted it, would apply only to used and useful property.[24]

Justice Brandeis confirmed that he had no quarrel with the used and useful standard when he joined the Court's opinion in *Denver Union Stock Yard Co. v. United States*, 304 U.S. 470, 475 (1938). That case expressly held that the Constitution required "a reasonable rate of return upon the value of the property used, at the time it is being used, to render the services," "[b]ut [the company] is not entitled to have included any property not used and useful for that purpose." [25]

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[23] Justice Brandeis criticized, among other things, what he regarded as the unsound basis of *Smyth v. Ames'* fair value standard (262 U.S. at 290), the difficulty of setting present value (*id.* at 292), the difficulty of judicial review of present value (*id.* at 297-98), and the unfairness of the present value standard (*id.* at 306-07). None of these difficulties inhere in the used and useful standard.

[24] As to this latter point, Justice Brandeis explained: "Historical cost . . . is the amount which normally should have been paid for all the property which is usefully devoted to the public service. It is, in effect, what is termed the prudent investment." 262 U.S. at 294 n.6. *See also id.* at 290 ("so long as the specific items of property are employed by the utility, their exchange value is not of legal significance"); *id.* at 308-09 ("What is now termed the prudent investment is, in essence, the same thing as that which the court has always sought to protect in using the term present value."). *Southwestern Bell* did not involve the question what property should be included in the rate base, but only how that property should be valued (*see id.* at 282, 287).

[25] The Court's later opinions have had little or no occasion to address the question directly, but they reflect an assumption that the used and useful test may constitutionally be employed to deter-

The prudent investment standard. Appellants' insistence that the constitutional standard encompasses recovery of all prudent investment is plainly incorrect. The Court has disclaimed any particular formula or any particular rate and has specifically declined to mandate the prudent investment standard. *See, e.g., Market Street Railway Co. v. Railroad Comm'n*, 324 U.S. 548, 567 (1945) (Commission is not required "to fix rates . . . on an investment after it has vanished, even if once prudently made"). The point is that not every disallowance of an expense rises to constitutional dimensions. Rather, there is a zone of reasonableness within which the overall rate, unchallenged here, may be set. *Permian*, 390 U.S. at 767; *Natural Gas Pipeline*, 315 U.S. at 585.[26]

Important reasons of comity and practicality argue against this Court's mandating any single standard for all state utility rate regulation. Such a requirement would further constitutionalize ratemaking, reducing flexibility for the States and creating docket problems for the Court.[27] States as a matter of policy use a variety of approaches in rate regulation and have devised

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mine the elements of value in the rate base. For instance, in *Natural Gas Pipeline*, the Court remarked (315 U.S. at 590): "It is only on the assumption that excess capacity is a part of the utility's equpiment used and useful in the regulated business, that it can be included as a part of the rate base on which a return may be earned." *See also Hope*, 320 U.S. at 606 n.12 (noting the statutory limitation of depreciation and amortization to property that is used and useful in service).

[26] *See, e.g., Mobil Oil Corp.*, 417 U.S. at 315 (noting the "common error . . . that certain provisions of the [rate] order can be isolated and viewed without regard to the total effect the order is designed to achieve").

[27] The era before *Hope* bears witness to the problems of a constitutional standard that requires this Court to scrutinize every ratemaking proceeding. By comparison, since *Hope* (at least until the last few years), the Court had nearly gotten out of the rate regulation business. Of course, this case concerns only operating expenses. Even prior to *Hope*, the Court had not been deeply involved in setting that component of the overall revenue allowance.

different ways to deal with the financial disaster resulting from cancellation of nuclear power generating units across the country.[28]

As the sole determinant of recovery, the prudent investment standard is particularly flawed. It may be the least economically defensible of all the regulatory approaches. It would "increase consumers' bills dramatically without producing any tangible benefit for the consumers" and would produce "results strikingly different from the results of erroneous investment decisions made by firms in unregulated markets."[29] It provides an incentive to overinvest in capital assets.[30] A regulatory process based solely on prudence would be expensive, intrusive, unpredictable, and probably futile, in part because a finding of prudent investment may reflect no more than the extraordinary difficulty of proving imprudence.[31] Nor is recovery of prudent investment in assets that are not used and useful necessary to enable the utility to attract new capital or to protect the long-term interests of existing stockholders.[32]

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[28] See, *e.g.*, Energy Information Administration, U.S. Dept. of Energy, *Nuclear Plant Cancellations: Causes, Costs, and Consequences* 33-57 (April 1983); Drobak, *supra* n.12, at 112-19; Pierce, *supra* n.8, at 517-20. Thus, it makes no difference whether "'the overwhelming weight of authority' support[s] the recovery through amortization *of* prudently incurred investment in cancelled electric generating projects." Brief for Appellants at 6, quoting the ALJ's report. This choice is a matter of policy, not constitutional imperative. Pennsylvania itself uses a number of different approaches. Since the enactment of Act 1985-62, 66 Pa. Cons. Stat. § 520, the PUC is authorized to permit recovery by amortization of prudently incurred investment in cancelled generating units.

[29] See Pierce, *supra* n.8, at 506.

[30] *See Jersey Central*, 810 F.2d at 1190 n.1, 1191 (Starr, J., concurring); Pierce, *supra* n.8, at 506-07, 559.

[31] See *id.* at 512 & n.80, 517, 538.

[32] The market in utility stocks and bonds is self-correcting. If application of the used and useful standard operates to increase

Appellants invoke "the utility's statutory duty to serve" (Brief at 29) as the basis for a constitutional requirement of recovery of prudent investment.[33] Contrary to their implication, utilities are managed not only to serve the public, but to earn profits for their investors. The utility's right to a reasonable rate of return and protected monopoly position are provided in exchange for service in a least-cost manner.[34] The so-called "regulatory compact" is plainly more complex than "we spend it, you pay for it." [35]

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the risk of disallowance, "[t]heoretically, in subsequent rate cases, this higher risk will manifest itself in a higher rate of return allowance being granted to the utility to 'compensate' for the additional risk." *New England Power Co.*, 42 FERC (CCH) ¶ 61,016, at 61,080 (Jan. 15, 1988). *Cf. Jersey Central*, 810 F.2d at 1172 (higher rate of return requested in view of disallowance of costs from the rate base).

[33] Appellants suggest (Brief at 3) that they were *required* to undertake the abortive construction, but the record supports at most a finding that they were encouraged to do so. The record also contains appellants' view that the PUC was powerless even to investigate their construction activities, much less to compel them. See n.8, *supra*.

[34] For example, the duty to serve can be fulfilled by purchase of electric power as well as building generating units. In recent years, the electric industry has had substantial excess capacity. See Pierce, *supra* n.8, at 525, 526, 527 n.177 (citing General Accounting Office Report).

[35] Moreover, if cancellation of the units at issue in this case was prudent, going ahead with the construction would likely have been either imprudent or unnecessary, or both. Regulatory commissions, in setting rates, generally disallow all costs associated with imprudent investment decisions; and return on costs resulting from investments that create excess capacity has also been precluded. See Pierce, *supra* n.8, at 511, 514-17. The effect of a rule prohibiting recovery of the costs of cancelled units is simply to impose a heightened incentive for management to cancel early. The magnitude of the incentive that States provide for prudent decisions by utility management, and the allocation of risk between the utility and the ratepayers, are clearly for legislative determination, and they do not raise constitutional questions.

Balancing of investor and consumer interests. At the outset, appellants' argument that the statutory mandate enforced by the Pennsylvania Supreme Court interfered with the PUC's exercise of its discretion in balancing investor and consumer interests can be put to one side. The PUC is a state agency, which must act within the scope of its legislative authorization. Pennsylvania's highest court has determined the correct interpretation of the applicable state law and concluded that the PUC's order rested on an incorrect interpretation.[36] The constitutionality of the state law itself plainly is not to be measured by the agency's mistaken application of it.

In any event, *Hope* and *Permian* do not support appellants' contention that the Pennsylvania Supreme Court did not properly balance investor and consumer interests. *Hope* and *Permian* do not mandate balancing any more than they require any particular ratemaking methodology or any particular rate; and this Court did not engage in any balancing in either case.

Hope indicated that "the fixing of 'just and reasonable' rates . . . involves a balancing of the investor and the consumer interests" and identified the factors relevant "from the investor or company point of view." 320 U.S. at 603. But the Court approved a reduction of rates ordered by the FPC without any balancing because "the end result in this case cannot be condemned under the Act as unjust or unreasonable from the investor or company viewpoint." *Ibid.* In *Permian*, the Court, echoing *Hope*, explained, "the [reviewing] court must determine whether the *order* may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable." 390 U.S. at 792 (emphasis added).[37]

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[36] Thus, the second question presented raises no more than a question of state law.

[37] Although it is not entirely clear whether the references to balancing in *Hope* and *Permian* pertained to the essentially legisla-

Appellants argue for a balancing of investor interests as though it would elevate those interests over the ratepayers'. In fact, because the ratemaking process itself is designed to produce an allowance that will afford a reasonable return to investors after payment of expenses (*see Hope*, 320 U.S. at 603; *see also Permian*, 390 U.S. at 792), the effect of balancing will generally be to *reduce* rates in order to reflect consumer interests.[38]

Although the Court has said that investors' interests are an important part of the calculus of setting rates, they are only a part. "'[R]egulation does not insure that the business shall produce net revenues'" (*Hope*, 320 U.S. at 603, quoting *Natural Gas Pipeline*, 315 U.S. at 590), for "the obvious reason that the hazard that the property will not earn a profit remains on the company in the case of a regulated, as well as an unregulated business." *Natural Gas Pipeline*, 315 U.S. at 590. *See Market Street Railway*, 324 U.S. at 566.

Appellants have shown no constitutional reason why a balance must be struck so as to permit recoupment of their expenditures for the cancelled plants. Appellants may not have been at fault when they risked a substantial sum on an investment that turned out to be worthless; but clearly, neither the public nor the ratepayers were at fault.[39] They were not consulted about appellants' plans, and the cancelled plants—which never proceeded beyond the planning stage—cannot conceivably benefit them. Under these circumstances, it was hardly unreasonable for Pennsylvania to decide that the balance should be struck in favor of the ratepayers, by precluding recovery of appellants' fruitless expenditures.[40]

In sum, *Hope* and *Permian* could support appellants' takings claim only if the exclusion of their costs in connection with the cancelled nuclear plants rendered their overall revenue allowance confiscatory. Although complaining that the Pennsylvania Supreme Court did not even cite *Hope* and *Permian*,[41] appellants have not alleged

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tive task of setting the appropriate revenue allowance, or to the judicial task of determining the constitutionality of that allowance, the Court obviously did not envision a constitutional balancing requirement with respect to every ingredient of the ratemaking process. The opinions demonstrate that the Court was concerned to avoid review of the details of that process, perhaps in recollection of the complexities in which it became enmeshed in attempting to determine the fair value of property under *Smyth v. Ames*.

[38] *See Market Street Railway*, 324 U.S. at 556, 568 (financial plight of company does not entitle it to charge exploitative rates); *Natural Gas Pipeline*, 315 U.S. at 607-08 (Black, J., concurring); *Washington Gas Light Co. v. Baker*, 188 F.2d 11, 15 (D.C. Cir. 1950), *cert. denied*, 340 U.S. 952 (1951); see also Pierce, *supra* n.8, at 506 (because the result would be a dramatic increase in electric bills without any tangible benefit, "full recovery of investment costs has no chance of emerging from the regulatory process as a solution").

[39] In *Natural Gas Pipeline Co. v. FERC*, 765 F.2d 1155, 1163 (D.C. Cir. 1985), the court upheld the denial of recovery of prudent expenditures on abandoned projects, noting: "At bottom, Natural's claim is that because it acted prudently, it cannot fairly be punished by nonrecovery of its expenses. But the problem of risk allocation in this case is not a problem of fault." *See also Jersey Central*, 810 F.2d at 1181 n.3; *Kentucky Utilities Co. v. FERC*, 760 F.2d 1321 (D.C. Cir. 1985).

[40] *See Permian*, 390 U.S. at 771, approving the FPC's determination that a "producer's inability to recover either its unsuccessful exploration costs or the full 12% return on its production investment would not, without more, warrant relief"; *Market Street Railway*, 324 U.S. at 527 (due process clause "has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces").

[41] Brief for Appellants at 11. This complaint is surprising because in the Pennsylvania Supreme Court, appellants between them cited *Permian* but once (Duquesne brief below at 32), and that was only in passing. They cited *Hope* only in passing (Penn Power brief below at 49), incorrectly (Duquesne brief below at 34-35, 36, 62), or for the noncontroversial proposition that it protects against a confiscatory rate of return (*id.* at 37, 38). Appellants did not argue that the used and useful standard was inconsistent with those cases; their argument was that the used and useful concept did not apply to operating expenses. See Brief of Duquesne below at 13, 18, 56; Brief of Penn Power below at 11, 38, 46, 47.

that the disallowance would make their revenue allowances confiscatory. Without an allegation of constitutional shortfall, appellants are not even entitled to a hearing, much less to prevail, on their takings claim.

II. DENIAL OF RECOVERY OF PRE-CONSTRUCTION COSTS IS NOT A TAKING UNDER TRADITIONAL CONCEPTS OF REGULATORY TAKINGS.

Appellants seek support in land use and other regulatory takings cases outside the utility context for their claim that the "reasonable expectations" of utility investors to be "made whole on their investment" "requir[e] recovery, *per se*, of a utility's prudent investment in cancelled electric generating units" (Brief at 26). The precedent in these areas, however, affords even less basis for appellants' contentions than the decisions in the special subspecies of takings law devised for rate regulation.

Appellants argue, first, that "[r]ecovery *of* prudently incurred costs . . . is deserving of protection *per se*" (Brief at 32 n.25) because to deny it is analogous to a physical invasion of their property. The denial of recovery of costs "takes from a person something that was once physically in his possession" (*ibid.*) and therefore must be "treated under a higher standard than regulations that merely diminish the expected value of an individual's property" (*id.* at 31-32 n.25, citing, *e.g.*, *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 435-38 (1982)). This argument merits no serious consideration because there is no physical property to be invaded.[42] *Cf. FCC v. Florida Power Corp.*, 107 S. Ct. 1107, 1112 (1987) (distinguishing *Loretto* on ground that statute gave no right to physical occupation of

[42] Appellants' efforts never proceeded beyond the planning stage. The plans themselves, of course, remain in appellants' possession, and, should they ever come to fruition, may then, in conjunction with the resulting facilities, be includable in the rate base.

another's property). Invasion of a mere pocketbook interest has never been per se prohibited.[43] No government action physically took anything from appellants or their investors. Whether viewed from the standpoint of the stockholders or of the utilities themselves, the investment in the cancelled plants in this case was voluntary, as was the decision to terminate the projects.

Second, appellants note (Brief at 27) that this Court has considered "whether governmental conduct interferes with 'reasonable, investment-backed expectations' in determing whether a taking has occurred," citing *Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979). Appellants argue, in effect, that they are constitutionally absolved from any risk of loss if an investment, prudent when made, proves to be worthless. Because appellants cite only part of the test set out in *Kaiser Aetna*, and fail to satisfy even that, their argument is insufficient.

In the regulatory takings area, the Court has repeatedly disclaimed a one-factor test or "any 'set formula' for determining when 'justice and fairness' require that economic injuries caused by public action be compensated by the government, rather than remain disproportionately concentrated on a few persons." *Kaiser Aetna*, 444 U.S. at 175 (citations and footnotes omitted). Instead, the Court has decided takings claims "by engaging

[43] The heightened protection against physical invasion is provided because "the right to exclude [others is] 'one of the most essential sticks in the bundle of rights that are commonly characterized as property.'" *Nollan v. California Coastal Comm'n*, 107 S.Ct. 3141, 3145 (1987) (citations omitted). Appellants' disappointed hopes of gain are not the kind of intangible property entailing "legal ownership" that is entitled to protection. *See Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1002 (1984). Of course, not even all regulation affecting real property interests constitutes a taking (*see, e.g., Keystone Bituminous Coal Ass'n v. DeBenedictis*, 107 S.Ct. 1232, 1244 n.18, 1249-50, 1250 n.27 (1987); *Hodel v. Virginia Surf. Min. & Recl. Ass'n*, 452 U.S. 264 (1981)), not even all physical invasions. *See Florida Power*, 107 S.Ct. at 1111-13; *PruneYard Shopping Center v. Robins*, 447 U.S. 74 (1980).

in essentially ad hoc, factual inquiries that have identified several factors—such as the economic impact of the regulation, its interference with reasonable investment backed expectations, and the character of the governmental action—that have particular significance." *Ibid.*

Economic Impact. The economic impact of the denial of recovery in this case of appellants' cancellation costs fails to rise to the level of a constitutionally significant loss under this Court's cases. The Court has rejected takings claims even where the regulation has been alleged to render the property nearly worthless (*see Andrus v. Allard*, 444 U.S. 51, 64-66 (1979)), or has resulted in a measurable loss as high as 87½% of the value. *See Hadacheck v. Sebastian*, 239 U.S. 394 (1915); *see also Euclid v. Ambler Realty Co.*, 272 U.S. 365 (1926) (75% diminution).[44] In this case, the excluded costs amounted to approximately ½ of 1% of annual revenues.[45] Appellants were allowed substantial annual revenue increases (by our calculation, 14.75% for Duquesne and 8.5% for Penn Power) even after excluding the disputed expenditures, and there is no suggestion that they were compelled to operate at a loss. *Cf. Penn Central Transportation Co. v. New York City*, 438 U.S. 104, 129, 136 (1978). It is well settled that appellants have no right to the most profitable use of their property (*see Andrus v. Allard*, 444 U.S. at 66; *Penn Central*, 438 U.S. at 125-27).

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[44] In some cases, the denial of any compensation for total loss of investment has been sustained. *See, e.g., Miller v. Schoene*, 276 U.S. 272 (1928); *Mugler v. Kansas*, 123 U.S. 623 (1887).

[45] There is no claim based on the effect of the exclusion of the costs on the value of the stock in appellants' companies. Of course, even if stock prices were adversely affected, the value of the stock would not be destroyed. The stock would retain value because of the expectation of future earnings. Moreover, as appellants themselves acknowledge (Brief at 24 n.20), the exclusion of costs in this case is a one-time occurrence. Under current Pennsylvania law, similar future costs can be recovered. 66 Pa. Cons. Stat. § 520.

Appellants describe the economic impact of the nonrecovered costs as though it could be viewed in isolation from their profitable utility business. The Court, however, has repeatedly held that the economic impact of government action is to be evaluated on the basis of the property as a whole. *See Keystone Bituminous Coal Ass'n v. DeBenedictis*, 107 S.Ct. 1232, 1248 (1987); *Andrus v. Allard*, 444 U.S. at 65-66; *Penn Central*, 438 U.S. at 130-31.[46]

Appellants' claims that the denial of recovery of costs would penalize their investors (Brief at 19) and leave them uncompensated for a risk that they did not assume (*id.* at 26-30, 33) are not supported in the record. The state supreme court explained that the used and useful standard has been the law in Pennsylvania at least since 1921 (J.S. App. 19a-20a). Thus, it is reasonable to assume, absent any evidence to the contrary, that in Pennsylvania utility revenue allowances reflect the fact that recovery of expenditures is not guaranteed. In fact, appellants' equity rates of return included risk premiums.

Reasonable investment-backed expectations. Appellants' repeated references to their investors' expectations and to the prudence of the expenditures at issue in this case ignore a crucial factor in the determination whether property interests and expectations are constitutionally protected. Not all investment-backed expectations are protected; they must be "*reasonable.*" *Kaiser Aetna*, 444 U.S. at 175 (emphasis added); *see Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1005-10 (1984).

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[46] In *Keystone*, for example, the coal companies contended that Pennsylvania's Mine Subsidence Act, by preventing them from mining 27 million tons of coal that they owned, had appropriated that coal for public purposes. 107 S.Ct. at 1249. The Court refused to treat this coal as "a separate segment of property for takings law purposes." *Ibid.* Rather, it viewed these 27 million tons in the context of the companies' overall operations and financial-backed expectations. *Ibid.*

This Court has made clear that

> "[p]roperty interests . . . are not created by the Constitution. Rather, they are created and their dimensions are defined by existing rules or understandings that stem from an independent source such as state law. . . ." *Board of Regents v. Roth*, 408 U.S. 564, 577 (1972). But a mere unilateral expectation or an abstract need is not a property interest entitled to protection.

Webb's Fabulous Pharmacies, Inc. v. Beckwith, 449 U.S. 155, 161 (1980). The Pennsylvania Supreme Court's authoritative construction of state law defeats appellants' claim to a reasonable expectation of compensation for all prudently incurred expenses. "Used and useful" has long been the law in Pennsylvania; it was applied to operating costs as early as 1944 (J.S App. 24a). As appellants recognize (Brief at 8 n.10), the effect of this rule is to "prevent a utility from *ever* receiving a return *of* or *on* its investment in . . . costs" of cancelled plants.

No more could the upheaval in the nuclear industry have been a secret to appellants. These units were planned in 1973 and cancelled in January 1980. During that time, 60 nuclear plants were cancelled, the first in 1972; 1974 was the last year that more units were planned than cancelled.[47] When appellants cancelled their plants, they had not yet received an NRC permit, without which construction would not have been possible. Against this backdrop, no reasonable expectation of completing the projects, much less of recovering all the costs, could have matured.

Appellants' expectations are grounded in a constitutional right that this Court has never recognized. The Constitution simply does not guarantee recovery of expenses, no matter how prudently incurred. In fact, rate regulation may reduce the value of investments or limit the rate of return to accommodate the public interest. *See Hope Natural Gas*, 320 U.S. at 601, 603; *Natural*

[47] See *Nuclear Plant Cancellations*, *supra* n.28, at 4-5.

Gas Pipeline, 315 U.S. at 590. Appellants' only constitutionally cognizable expectation was a nonconfiscatory revenue allowance; and they make no claim that their overall revenues are constitutionally insufficient. Their vision that utility investments are risk-free is not protected because it is not reasonable.

Character of the governmental action. Perhaps the most elusive aspect of appellants' takings claim is what, if anything, Pennsylvania took from them, indeed, whether Pennsylvania did anything at all to affect their property interests.[48] Appellants decided to build nuclear plants. They then decided to cancel those plants. The former decision was likely motivated by the advantages perceived, in 1973, of nuclear power; the latter decision by the loss of those advantages. But the Commonwealth mandated neither decision and was not responsible for the loss of advantage.[49]

Nevertheless, appellants insist that the Commonwealth has "taken" something from them. It appears to be nothing other than the ability to charge consumers the costs of ill-fated, unproductive studies and planning for their failed venture. The finding of a taking absent physical invasion of real property is rare, and the Court has resisted extending the protection of the "right to exclude

[48] It may be argued that this third factor is the most important, or that it is most likely to be determinative. *See, e.g., Nollan*, 107 S.Ct. at 3145; *Hodel v. Irving*, 107 S.Ct. 2076, 2083 (1987); *Kaiser Aetna*, 444 U.S. at 179-80; *Loretto*, 458 U.S. at 442 (Blackmun, J., dissenting). It is here that the Court considers whether the government has authorized a physical invasion or only imposed regulation.

[49] The causes of the reversal in fortune of the nuclear industry have been well documented. They include the OPEC oil embargoes and the ensuing conservation efforts, inflation, and the nuclear disaster at Three Mile Island. See Brief for Appellants at 17; *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, No. 86-1970 (June 24, 1988), slip op. 4 n.5; *Jersey Central*, 810 F.2d at 1206 (Mikva, J., dissenting); *Nuclear Plant Cancellations*, *supra* n.28, at 19-21, 26; Phillips, *supra* n.3, at 18; Pierce, *supra* n.8, at 502-05.

others" beyond that context. Where the Court has found a taking, it has been because of the destruction of a protected ownership interest (*see, e.g., Hodel v. Irving*, 107 S.Ct. 2076, 2083-84 (1987); *Monsanto*, 467 U.S. at 1010-14), not justified by the police power. *See Webb's Fabulous Pharmacies*, 449 U.S. at 163-64. Here, appellants have identified no protected property right; and the public interest in price regulation is well settled. *See, e.g., Pennell v. City of San Jose*, 108 S.Ct. 849, 857-59 & nn. 6, 8 (1988).

Because appellants' nuclear investment has been rendered worthless, and the profitability of their business diminished, they seek to recover for their mistake from the government. But Pennsylvania did not destroy the value of their investment, and the "loss of future profits—unaccompanied by any physical property restriction—provides a slender reed upon which to rest a takings claim." *Andrus v. Allard*, 444 U.S. at 66.

CONCLUSION

For the foregoing reasons, the judgment of the Supreme Court of Pennsylvania should be affirmed.

Respectfully submitted,

ROBERT L. BEZEK, JR.
ANDERSON, BYRD & RICHESON
Second & Main, P.O. Box 7
Ottawa, KS 66067
(913) 242-1234

BRIAN J. MOLINE
712 S. Kansas Avenue
Suite 201
Topeka, KS 66603
(913) 354-8531
Of Counsel

BENNA RUTH SOLOMON *
Chief Counsel
JOYCE HOLMES BENJAMIN
BEATE BLOCH
STATE AND LOCAL
LEGAL CENTER
444 N. Capitol Street, N.W.
Suite 349
Washington, D.C. 20001
(202) 638-1445

* *Counsel of Record for the* Amici Curiae

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IN THE SUPREME COURT OF THE UNITED STATES

October Term 1987

DUQUESNE LIGHT COMPANY
and
PENNSYLVANIA POWER COMPANY,
Appellants

v.

DAVID M. BARASCH, ET AL.,
Appellees

On Appeal from the Supreme Court of Pennsylvania

BRIEF FOR CONSUMER FEDERATION OF AMERICA, ENVIRONMENTAL ACTION, AND CITIZEN/LABOR ENERGY COALITION

Scott Hempling
Counsel of Record

Environmental Action Foundation
1525 New Hampshire Ave.
Washington, DC 20036
(202) 745-4871

Roger Colton

72 Maple St.
Belmont, MA 02178

June 30, 1988

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INTEREST OF AMICI CURIAE

Consumer Federation of America ("CFA"), a non-profit organization founded in 1968, is the nation's largest consumer advocacy organization. CFA's membership encompasses more than 200 national, state and local consumer, senior citizen, low-income, union, farm, labor, public power and cooperative organizations representing more than 35 million people. **Environmental Action ("EA")** is a non-profit, environmental research and education organization based in Washington, D.C., with members located throughout the United States. **Citizen/Labor Energy Coalition ("C/LEC")**, founded in 1978, is a coalition of labor, citizen, religious and community organizations working on energy issues affecting low and moderate income groups.

Collectively, amici represent consumers of electricity and residents of communities affected by electric utility investment

decisions. They seek to ensure that regulatory treatment of investment by investor-owned utilities is responsive to consumer, community and environmental concerns.

SUMMARY OF ARGUMENT

Section 1315, the Pennsylvania statute[1] denying Appellants retail rate recovery of their approximately $50 million investment in cancelled nuclear plants, is not confiscatory. At the time they made this investment, Appellants had no property interest in exacting charges for a product their customers cannot use. Section 1315, as interpreted by the Pennsylvania Supreme Court in the decision below, merely codified the existing ban on such charges. Therefore, Section 1315 does not work a "taking" under the Fifth Amendment to the U.S. Constitution.

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[1] 66 Pa.C.S. sec. 1315.

This Court generally has examined takings challenges by engaging in "essentially ad hoc, factual inquiries." In the special context of utility regulation, where clear risk assignment is essential to the efficient implementation of long-term capacity planning, the ad noc approach does not work well. Amici therefore propose a constitutional test which (1) adheres to this Court's takings precedent; (2) leaves regulatory jurisdictions free to choose among various methods of assigning and compensating for risk; but (3) avoids the inherent unpredictability of the ad hoc approach.

Specifically, a regulatory act is a taking only if it (a) does not advance a legitimate state interest; (b) has a character which conflicts with a fundamental attribute of property ownership; or (c) causes a diminution in value which is inconsistent with distinct,

reasonable, investment-backed expectations.

Appellants ask this Court to impose a "prudent investment rule" as the constitutional standard. Such a rule would supersede states' diverse experiments in risk assignment, while violating this Court's admonition that the result, not the method, must control constitutional review of utility regulatory decisions.

ARGUMENT

I. APPELLANTS' INSISTENCE ON AUTOMATIC RECOVERY OF PRUDENT INVESTMENT IN CANCELLED PLANT CONFLICTS WITH THIS COURT'S TAKINGS PRECEDENT

A. The Legal Test for Takings in the Regulatory Context

This Court generally has "examined the 'taking' question by engaging in essentially ad hoc, factual inquiries...." Kaiser Aetna v. United States, 444 U.S. 164, 175 (1979). These "factual inquiries" generally involve two analytical steps. First, the Court identifies the relevant

factors. Four factors have appeared most frequently: (1) legitimacy of the "public purpose," Keystone Bituminous Coal Ass'n v. DeBenedictis, ___ U.S. ___, 107 S.Ct. 1232, 1242 (1987); (2) "character of the government action," Penn Central Transportation Co. v. New York City, 438 U.S. 104, 124 (1978); (3) "economic impact," Hodel v. Irving, ___ U.S. ___, 107 S.Ct. 2076, 2082 (1987); and (4) "interfere[nce] with distinct investment-backed expectations," Penn Central, supra, 438 U.S. at 124.

Second, the Court determines what role each factor should play in the analysis of the challenged governmental action. Perhaps reflecting the "ad hoc" nature of the Court's takings inquiries, the role of each factor has varied. For example, in Loretto v. Teleprompter Manhattan CATV, 458 U.S. 419 (1982), the "character" of the government action -- requiring apartment

building owners to permit cable television companies to attach equipment to building roofs -- made it a taking per se. But in Hodel v. Irving, supra, the Court appeared to "weigh" and "balance" character along with the other three factors. [2] Cf., Kaiser Aetna, supra, 444 U.S. at 178 and n.9 (while "[m]ore than one factor" contributed to Court's finding of a taking, Court did not decide "whether in some

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[2] The statute challenged in Hodel v. Irving prohibited Sioux Indians with less than two percent interests in certain parcels of land to pass on those interests to their heirs. They could either sell their interests to other tribal members, or have their interests escheat to the tribe upon their death. In invalidating the statute, the Court strongly suggested that the statute's character -- a "total abrogation" of a fundamental property right [the right to pass on property to heirs] -- made it a taking per se. See 107 S.Ct. at 2083-84. Yet the Court also appeared to treat the four factors as items to be weighed independently and balanced. See 107 S.Ct. at 2083 ("[a]lso weighing weakly in favor of the statute ... is something of an 'average reciprocity of advantage'"); and n.2 (describing the analysis as "the Penn Central balancing test").

circumstances one of these factors by itself may be dispositive").

Amici do not seek to modify the Court's general approach to takings cases. But in the specific context of utility ratemaking, where clear risk assignment is central to efficient, long-term capacity planning, the unpredictability inherent in the ad hoc approach does not work well. The need for predictability aside, the various interests affected by regulatory policy -- utility management, shareholders, competitors and customers -- hold conflicting views on such key planning questions as who should bear the economic risks, and capture the economic benefits, of utility decisionmaking.

We therefore propose a framework for analyzing takings claims in the context of utility ratemaking. This framework (1) assures that regulatory treatment of utility investment is predictable and

internally consistent; (2) protects utility property interests; and (3) leaves the various interests free to debate, in advance of construction, the policy issue of who should bear risk and capture benefits. That framework is as follows:

First, where a utility volunteers for the duty and privilege of providing franchise service, the regulatory agency (or legislature) is free to assign in advance, in any manner it wishes, the economic risks associated with providing such service. The agency's policy must be consistent with this Court's "public purpose" and "character" requirements. Second, where such advance risk assignment creates expectations that rise to the level of a property right, the utility is entitled to rates which are consistent with those expectations. As with all takings cases, the burden rests with the utility to demonstrate that rates conflict with

distinct, reasonable, investment-backed expectations.

Appellants' attack on Section 1315 is circular. It boils down to the following syllogism: (1) denial of recovery of "property dedicated to public use" is a taking; (2) cancelled plant is "property dedicated to public use"; (3) therefore, denial of recovery of cancelled plant is a taking. Appellants beg one of the key questions in this case: whether their decision to build the cancelled plants was based on a distinct, reasonable, investment-backed expectation of freedom from economic risk.

"We cannot start the process of decision by calling such a claim as we have here a 'property right'; whether it is a property right is really the question to be answered." U.S. v. Willow River Co., 324 U.S. 499, 502-03 (1945). As discussed below, that question must be answered in

the negative.

B. The Pennsylvania Statute Embodies a Proper Public Purpose

1. The Legal Standard

"Public purpose" review ensures that the "alleged 'taking' is for a valid 'public use' within the meaning of the Fifth Amendment." Hodel v. Irving, supra, 107 S. Ct. at 2089 (Stevens, J., concurring). The general test is whether the statute forces "some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole." Armstrong v. United States, 364 U.S. 40, 49 (1960).

That a statute leaves the claimant "more burdened than benefitted" does not invalidate it. Penn Central, supra, 438 U.S. at 133-35. As this Court recently declared: "While each of us is burdened somewhat by such restrictions, we, in turn benefit greatly from the restrictions that

are placed on others....These restrictions are 'properly treated as part of the burden of common citizenship.'" [3] This requirement of "reciprocity of advantage" will be met where the statute benefits "widely varying interests," Keystone, supra, 107 S.Ct. at 1242-43, or where there is "substantial overlap" between the burdened and benefited citizens, Hodel v. Irving, supra, 107 S.Ct at 2083. Exemplifying these characteristics would be a statute designed to protect a state's economy. [4]

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[3] Keystone, supra, 107 S.Ct. at 1245 (quoting Kimball Laundry Co. v. United States, 338 U.S. 1, 5 (1949)). See also Pennsylvania Coal Co. v. Mahon, 260 U.S. 393, 415 (1922) ("reciprocity of advantage" justifies burdening some more than others).

[4] See, e.g., Keystone, 107 S.Ct. at 1243 ("fiscal integrity of the [affected] area" a proper goal); United States v. Central Eureka Mining Co., 357 U.S. 155 (1958) (Government order closing gold mines so that skilled miners would be available for other mining work based on proper purpose); Miller v. Schoene, 276 U.S. 272, 279 (1928) (destruction of red cedar trees

This Court will not second-guess legislative judgments as to whether a regulatory scheme benefits the public at large. [5] And in determining legislative purpose, this Court will defer to statutory interpretations reached by lower courts. [6] Finally, the burden of demonstrating the unreasonableness of government's use of the police power lies with the plaintiff. [7]

2. Application

Section 1315 prohibits Appellants from

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to save nearby apple trees a proper purpose where apple industry was more important to state's economy).

[5] See, e.g., Penn Central, supra, 438 U.S. at 134 (deferring to City Council's judgment that "the preservation of landmarks benefits all New York citizens and all structures, both economically and by improving the quality of life in the city as a whole...").

[6] Keystone, supra, 107 S.Ct. at 1242 and n.15.

[7] See Goldblatt v. Hempstead, 369 U.S. 590, 596 (1962) ("Our past cases leave no doubt that appellants had the burden on 'reasonableness.'...").

recovering cancelled plant costs in retail rates. It effectively bars Appellants from charging captive ratepayers for a product they cannot use, did not request and do not want. The clear purpose of the statute is to prevent what the Pennsylvania Legislature deemed to be monopoly abuse of captive customers. The courts have found that purpose to be proper, repeatedly. [8]

Appellants intimate (Br. at 19) that Section 1315's purpose is improper because

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[8] See, e.g., State of Missouri ex rel. Southwestern Telephone Co. v. Public Service Commission, 262 U.S. 276, 290 (1923) (Brandeis, J., dissenting) (public interest includes protection from rates which are "prohibitive, exorbitant, or unduly burdensome to the public"); Permian Basin Area Rate Cases, 390 U.S. 747, 768-69 (1968) (noting public interest in satisfying consumers' concern about reasonable prices); Washington Gas & Light Co. v. Baker, 188 F.2d 11, 15 (D.C. Cir. 1950) (protection of consumers from exorbitant rates is a proper public purpose), cert. denied, 340 U.S. 952 (1951); Jersey Central Power & Light Co. v. FERC, 810 F.2d 1168, 1181 n.34 (1987) (ratepayer must be protected from "exploitation," regardless of the resulting impact on the utility).

it merely favors one set of private interests (ratepayers) over another set (shareholders). But reasonable rates benefit utilities as well as ratepayers. Reduced electricity costs make the utility's business customers more competitive, and leave residential customers with more disposable income. The resulting economic development can increase utility revenues. Section 1315 thus embodies the "reciprocity of advantage" which has vindicated numerous other regulatory actions. [9]

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[9] The legitimacy of a statute's purpose is, of course, "subject to independent scrutiny by this Court." Keystone, supra, 107 S.Ct. at 1256 (Rehnquist, J., dissenting). But only the state courts can determine what the statutory purpose was. Moreover, only the state can make the policy judgments which determine when the public interest is served by placing limits on certain private interests, and how to design those limits. Cf., Hawaii Housing Authority v. Midkiff, 467 U.S. 229, 242 (1984) ("'whether in fact the provisions will accomplish the objectives is not the question: the [constitutional requirement] is satisfied

C. The Pennsylvania Statute Does Not Extinguish a Fundamental Attribute Of Ownership

1. The Legal Standard

The "character of the government action" is a factor distinct from the "purpose" of the action. [10] In Loretto, supra, the Court held that "a permanent physical occupation authorized by government is a taking without regard to the public interests that it may serve."

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if ... the ... [State] Legislature rationally could have believed that the [Act] would promote its objective'") (quoting Western & Southern Life Insurance Co. v. State Bd. of Equalization, 451 U.S. 648, 671-72 (1981)) (quoted in Keystone, supra, 107 S.Ct. at 1255-56 n.3 (Rehnquist, J., dissenting)).

[10] See Keystone, supra, 107 S.Ct. at 1244 n.18 ("a 'taking' may more readily be found when the interference with property can be characterized as a physical invasion by government, ... than when interference arises from some public program adjusting the benefits and burdens of economic life to promote the common good") (citations omitted). See also Penn Central, supra, 438 U.S. at 124; Loretto, supra, 458 U.S. at 426.

458 U.S. at 426. [11]

Circumstances warranting per se invalidation on grounds of character are "very narrow," Loretto, supra, 458 U.S. at 441; or "extraordinary," Hodel v. Irving, supra, 107 S.Ct. at 2083. Thus economic regulation which completely prohibits use of particular property is still economic regulation, not physical appropriation. [12]

2. Application

Appellants argue (Br. at 31-32 n.25)

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[11] Cf., Kaiser Aetna, supra, 444 U.S. at 176 (right to exclude is "one of the most essential sticks in the bundle of rights that are commonly characterized as property"); Hodel v. Irving, supra, 107 S.Ct. at 2083 (statute "amounts to virtually the abrogation of [a] right ... [which] has been part of the Anglo-American legal system since feudal times").

[12] See, e.g., Keystone, 107 S.Ct. at 1244 n.18 ("the Court has repeatedly upheld regulations that destroy or adversely affect real property interests"); Agins v. City of Tiburon, 447 U.S. 255, 262 (1980) (restrictions on economic development do not, alone, amount to a taking where they do not "extinguish a fundamental attribute of ownership").

that Section 1315's denial of recovery is analogous to "physical invasion by government." The analogy is unacceptably strained. The statute does not work a physical invasion, and it does not appropriate property. Rather, it "restrains uses of property." Keystone, supra, 107 S.Ct. at 1245. Specifically, Section 1315 deprives Appellants of their wish to charge captive customers for a product they do not want. That wish hardly constitutes a right which "has been part of the Anglo-American legal system since feudal times." Hodel v. Irving, supra, 107 S.Ct. at 2083.

Contrary to Appellants' assertion, Loretto, supra, does not apply to the instant case. By specifically authorizing permanent physical occupation, the Loretto statute prevented the property owner from making any use of the occupied area. In contrast, as discussed in Part I.D.2,

infra, Appellants remain free to use the fruits of their $50 million investment, with one exception: they may not impose the costs on retail ratepayers. As the Loretto Court stated:

> To borrow a metaphor, cf. Andrus v. Allard, 444 U.S. 51, 65-66 (1979), the government [in authorizing a physical invasion] does not simply take a single 'strand' from the 'bundle' of property rights: it chops through the bundle, taking a slice of every strand.
>
> Property rights in a physical thing have been described as the rights "to possess, use and dispose of it." [citation omitted] To the extent that the government permanently occupies physical property, it effectively destroys each of these rights.

Loretto, supra, 458 U.S. at 435 (emphasis in original). Because Appellants remain free to utilize their cancelled plant investment in other ways, they have lost only one strand, if any. [13]

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[13] We argue in Part I.D.4, infra, that Appellants had no reasonable expectation, and therefore no property interest, in charging captive ratepayers for a product

D. The Pennsylvania Statute Has No Economic Impact Which Conflicts With Distinct, Reasonable, Investment-Backed Expectations

1. The Legal Standards

A taking occurs where (a) there is a diminution of value, (b) caused by government action, (c) which is inconsistent with distinct, reasonable, investment-backed expectations. We discuss each of these factors in turn.

a. Did the utility suffer a diminution of value"? The takings analysis proceeds only if the statute necessarily "denies an owner economically viable use of his land." Hodel v. Virginia Surface Mining and Reclamation Ass'n, Inc., 452 U.S. 264, 294-96 (1981). To establish the absence of economic viability -- an "uphill battle," Keystone, supra, 107 S.Ct. at 1247 -- the claimant must clear three hurdles.

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they do not want. Consequently, Appellants never owned the strand they claim to have lost.

First, the claimant cannot simply carve out the affected property and insist it was taken. "[W]here an owner possesses a full 'bundle' of property rights, the destruction of one 'strand' of the bundle is not a taking because the aggregate must be viewed in its entirety." Andrus v. Allard, supra, 444 U.S. at 65-66. [14]

Second, the claimant must prove there are no alternative uses for the affected property. This requirement flows from the

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[14] In Andrus, it was "crucial that appellees retain the rights to possess and transport their property,...to donate or devise the protected birds, and to exhibit the artifacts for an admissions charge." 444 U.S. at 66. And in Keystone, supra, appellants argued unsuccessfully that the statute constituted a taking of the 27 million tons required to be left in the ground. That coal was not a separate segment of property for takings law purposes. 107 S.Ct. at 1248-49. See also Penn Central, supra, 438 U.S. at 130-31 (rejecting argument that "air rights" above the terminal constituted a separate segment of property; Court must "focus ... on the nature of the interference with rights in the parcel as a whole).

principle that there is no property interest in the "most beneficial use of the property," even where the claimant already had devoted capital to that use. Penn Central, supra, 438 U.S. at 125. Thus where the challenged statute (a) merely regulated the mining conditions, but did not categorically prohibit surface coal mining, and (b) did not regulate alternative uses of coal-bearing lands, claimants could not demonstrate that "mere enactment" deprived them of economically viable use of their property. Hodel v. Virginia Surface Mining Mining, supra, 452 U.S. at 296-97. [15]

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[15] See also Goldblatt v. Hempstead, supra, 369 U.S. at 597 n.4 (that appellants made improvements on the lot previously was "not indicative of the loss appellants would presently suffer if the mine were closed; perhaps the improvements are commercially saleable"); Lake Nacimiento Ranch v. San Luis Obispo County, 830 F.2d 977, 981 (9th Cir. 1987) (the test for whether a development restriction denies a plaintiff the economically viable use of its property focuses on the existence of

Third, the utility complaining of a loss must show it has not been compensated already for the risk of loss. It must demonstrate that either (1) the state explicitly refused compensation for risk; or (2) the rate of return methodology imposed by the state during the investment period did not compensate for risk. Resolving the risk-compensation issue requires a state-specific factual analysis. A claimant may not avoid the required factual analysis by asserting to this Court that the specific rate methodology necessarily fails to reflect risk. This Court has properly refused to validate or invalidate facially any particular ratemaking methodology. Federal Power Commission v. Hope Natural Gas Co., 320

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permissible uses).

U.S. 591, 602 (1943). [16]

b. Was the diminution caused by government action? Diminution alone does not establish a taking. The claimant must show that the challenged government action actually caused the claimed diminution. [17] In short, if the diminution would have occurred without the statute, it cannot be

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[16] Amicus Pennsylvania Electric Association ("PEA") asserts (Br. at 23) that the state should bear the burden of demonstrating that the utility has already been compensated for risk. But in takings cases this Court has placed the burden of proof on the claimant, consistently. PEA offers no reason for changing this rule in the specific instance of proving failure to compensate for risk. The evidence on this issue is a matter of public record (primarily, state commission orders and the underlying expert testimony). The state, therefore, has no special ability to produce the proof. The burden must remain with the utility.

[17] See Keystone, supra, 107 S.Ct. at 1248 (rejecting takings claim in part because "the categories of coal that must be left [in the ground] for Section 4 purposes and other purposes are not necessarily distinct sets, and there is no information in the record as to how much coal is left in the ground solely because of Section 4").

attributed to the statute.

c. Did the government-induced diminution conflict with distinct, reasonable, investment-backed expectations? To analyze this question fully, we first must clarify (a) the logical relationship between expectations and diminution; and (b) how expectations become property rights.

i. Economic impact and investment-backed expectations are not independent factors; they are causally linked. Unless the economic impact results from interference with expectations, that impact lacks constitutional significance. The reason: There is no taking without governmental destruction of a property right. [18] In the context of economic

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[18] Note that governmental destruction of a property right is necessary, but not sufficient, to establish a taking. See Andrus, supra, 444 U.S. at 65-66; Keystone, supra, 107 S.Ct. at 1248-49.

regulation, the property right claimed is the right to earn money conducting a specific business. If any right exists, it arises from, and is delimited by, distinct expectations concerning that business. If there are no expectations, there are no property rights with which the government can interfere. And if there is no interference with a property right, then the alleged economic impact must lack constitutional significance.

The Court's decisions confirm this causal relationship between economic impact and expectations. Explaining its rejections of various takings challenges, the Court stated: "[W]hile the challenged government action caused economic harm, it did not interfere with interests that were sufficiently bound up with the reasonable expectations of the claimant to constitute 'property' for Fifth Amendment purposes."

Penn Central, supra, 438 U.S. at 124-25. [19] Indeed, the Court's language indicates that economic impact analysis effectively includes expectations analysis: "The economic impact of the regulation on the claimant and, particularly, the extent to which the regulation has interfered with distinct investment-backed expectations are, of course, relevant considerations." Id. [20]

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[19] See also Keystone, supra, 107 S.Ct. at 1249 (amount of coal required to be left in ground must be "viewed in the context of ... financial-backed expectations").

[20] Cf., Lake Nacimiento, supra, 830 F.2d at 981 n.3 (expectations analysis is relevant only to "as-applied" challenges, where "severity of the regulation's impact on the specific plaintiffs" is at issue).

The Court in Hodel v. Irving also appears to have linked diminution and expectations in a causal relationship. After describing the nature of the diminution -- loss of the right to pass on property -- the majority opinion implied that the right was not very valuable because appellees had only "dubious" expectations in exercising it. Hodel v. Irving, supra, 107 S.Ct. at 2083. Justice Brennan's concurrence (id. at 2084) also emphasizes the causal link. He found that

The link between diminution and expectations surfaces in one further guise. We noted previously that in measuring economic impact, the Court will not carve out the affected property interest and treat it as "taken." The reason: the claimant has no reasonable expectation of using his full bundle of rights without interference. Thus in Penn Central, supra, the Court disagreed with the claimant that "the full use of air rights [was] so bound up with the investment-backed expectations of appellants that governmental deprivation of these rights invariably -- i.e., irrespective of the impact of the

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the economic impact interfered with specific expectations created by "unique negotiations." Those expectations, he argued, distinguished that case from Andrus v. Allard, where a significant diminution in value survived a taking challenge.

While both the majority opinion and Justice Brennan's concurrence appear to agree on the causal relationship between diminution and expectations, they reached opposite conclusions as to what claimant's expectations were.

restriction on the value of the parcel as a whole -- constitutes a 'taking.'" 438 U.S. at 130 n.27.

ii. "[N]ot all economic interests are 'property rights'; only those economic advantages are 'rights' which have the law back of them...." U.S. v. Willow River Co., supra, 324 U.S. at 502. The question is how to distinguish between economic interests and propery rights. For example, some rights lie at the core of Anglo-Saxon property law. [21] Other rights may flow from expectations created by government consent. [22]

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[21] See, e.g., Kaiser Aetna, supra, 444 U.S. at 179-80 ("'right to exclude' [is] universally held to be a fundamental element of the property right"); Loretto, supra, 458 U.S. at 441 (property owner has "historically rooted expectation of compensation" for physical invasion); Hodel v. Irving, supra, 107 S.Ct. at 2083 (right to pass on property "has been part of the Anglo-American legal system since feudal times")

[22] Kaiser Aetna, supra, 444 U.S. at 179.

But expectations do not create property rights automatically. [23] As this Court has declared: "Rights, property or otherwise, which are absolute against all the world are certainly rare...." Willow River Co., supra, 324 U.S. at 510 (1945). [24] To get from expectation to property right, the claimant must answer a host of other questions. [25] And whether an expectation

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[23] See Penn Central, supra, 438 U.S. at 125 (citing cases in which "the challenged government action caused economic harm, [but] did not interfere with interests that were sufficiently bound up with the reasonable expectations of the claimant to constitute 'property' for Fifth Amendment purposes").

[24] See also id. at 499 ("a strategic position for the development of power does not give rise to right to maintain [that positi

[25] In Willow River Co., supra, the claimants, operators of a hydroelectric generation business, owned land adjacent to a river. Based on that ownership, they asserted a property interest in maintaining a certain water level conducive to operation of their plants. In considering the claim, the Court analyzed the following issues: "the claimant's rights in the land to which he claims the water rights to be appurtenant or incidental; on the navigable

amounts to a property right depends in part on the law existing at the time the plaintiff claims to have acquired his property interest. [26] In determining whether state law creates a property right, this Court will defer to lower court interpretations. [27]

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or non-navigable nature of the waters from which he advantages; on the substance of the enjoyment thereof for which he claims legal protection; on the legal relations of the adversary claimed to be under a duty to observe or compensate his interests; and on whether the conflict is with another private riparian interest or with a public interest in navigation." 324 U.S. at 503.

[26] As the Chief Justice has written: "Reliance on state law is necessitated by the fact that 'property interests ... are not created by the Constitution. Rather, they are created and their dimensions are defined by existing rules or understandings that stem from an independent source such as state law...." Keystone, supra, 107 S.Ct. at 1259-60 (Rehnquist, J., dissenting). See also Andrus v. Allard, supra, 444 U.S. at 64-65 n.21 ("timing" of acquisition of a property interest, relative to statutes affecting that interest, is relevant to analysis of investment-backed expectations).

[27] Keystone, supra, 107 S.Ct. at 1250.

Finally, to qualify as property rights, expectations must be "distinct." Penn Central, supra, 438 U.S. at 136-37. For Fifth Amendment purposes, "a mere unilateral expectation or an abstract need is not a property interest entitled to protection." Webb's Fabulous Pharmacies, Inc. v. Beckwith, 449 U.S. 155, 161 (1980) (citations omitted). [28]

Before applying these three questions to this case, we must confront one preliminary issue: Appellants' facial challenge to Section 1315.

2. Appellants' Facial Challenge to Section 1315's Economic Impact Must Fail

Appellants challenge Section 1315 on both "facial" (Br. at 23-26) and

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[28] See also Board of Regents v. Roth, 408 U.S. 564, 577 (1972) ("To have a property interest in a benefit, a person clearly must have more than an abstract need or desire for it. He must have more than a unilateral expectation of it. He must, instead, have a legitimate claim of entitlement to it.").

"as-applied" (Br. at 14-20) grounds. Their facial challenge effectively seeks invalidation of any statute imposing the risk of prudent but uneconomic investment on those initiating the investment. After discussing the different analyses applicable to facial and as-applied challenges, we show that Appellants' facial challenge must fail.

This Court has stated:

> [W]e have recognized an important distinction between a claim that the mere enactment of a statute constitutes a taking and a claim that the particular impact of government action on a specific piece of property requires payment of just compensation.

Keystone, supra, 107 S.Ct. at 1247. A facial challenge is appropriate when the regulation has an improper public purpose or an "extraordinary" character, due to the Court's per se rules in these areas. [29]

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[29] See, e.g., Pennsylvania Coal, supra (invalidation based on facial challenge to public purpose); Loretto, supra

In the area of economic impact, the matter is more complicated. Depending on whether the challenge is facial or as-applied, different standards will apply. For a facial challenge, the question is whether the government action necessarily "denies an owner economically viable use of his land." Hodel v. Virginia Surface Mining, supra, 452 U.S. at 294-96. [30] An as-applied challenge, in contrast, requires "careful assessment of the impact of the regulation" on the specific affected property, including an inquiry into (1) the extent of interference with distinct expectations, and (2) the permissible remaining uses of the property. Penn Central, supra, 438 U.S. at 136-37.

(invalidation based on facial challenge to character of government action).

[30] Making this type of claim involves an "uphill battle," Keystone, supra, 107 S.Ct. at 1247; and a "heavy burden," id. at 1250.

Where expectations are at issue, the courts have not welcomed facial challenges. "[T]he submission that appellants may establish a 'taking' simply by showing that they have been denied the ability to exploit a property interest that they heretofore had believed was available for development is quite simply untenable." Penn Central, supra, 438 U.S. at 130. That conclusion comports with this Court's view, reiterated just last term, that a facial challenge is a poor vehicle for testing the constitutionality of statutes. [31]

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[31] "[T]he court below ignored this Court's oft-repeated admonition that the constitutionality of statutes ought not be decided except in an actual factual setting that make such a decision necessary. [Citations omitted] Adherence to this rule is particularly important in cases raising allegations of an unconstitutional taking of private property." Keystone, supra, 107 S.Ct. at 1247. See also Williamson Planning Commission v. Hamilton Bank, 473 U.S. 172, 190-91 and n.12 (1985) (the question whether a regulation interferes with reasonable, distinct investment-backed expectations belongs in an as-applied challenge, not a facial challenge).

The foregoing principles support the causal link drawn in Part I.D.1.c, supra, between the economic impact factor and the expectations factor. Unless the economic diminution flows from a breach of expectations, we argued above, the economic impact has no constitutional significance. Before determining whether economic impact is constitutionally relevant, therefore, one must investigate the claim of expectations, including all circumstances consistent or inconsistent with such claim. That factual investigation is impossible in the context of a facial challenge.

Appellants do not make the traditional facial challenge -- that Section 1315 renders their property economically unviable. Rather, their facial challenge proceeds argue as follows: (1) we had an expectation of recovery of the specific investment; (2) Section 1315's denial of recovery conflicted with that expectation;

(3) therefore, Section 1315 is a taking. That argument collides with this Court's instructions not to resolve expectations questions in the context of a facial challenge.

We turn now to Appellants' as-applied challenges.

3. Appellants Have Not Demonstrated That Section 1315, As Applied, Diminishes Shareholder Value

a. Appellants have not shown the absence of alternative uses for their investment. To establish any diminution in value, Appellants must show, inter alia, that they cannot put their investment to alternative uses. Appellants bear the burden of proof on this issue. [32]

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[32] See Andrus v. Allard, supra, 444 U.S. at 66 (claimants lost because they could not show they were "unable to derive economic benefit from the artifacts"); Penn Central, supra, 438 U.S. at 136 ("it simply cannot be maintained, on this record, that appellants have been prohibited from occupying any portion of the airspace above the Terminal").

Appellants have made no such showing. Nor could they, since they can put their investment to a variety of uses. For example:

Appellants' cancellation decision was voluntary. They can reverse that decision and continue to build one or more plants. Then they can seek buyers on the wholesale market from whom to recover their investment. [33] Or, the engineering reports and other fruits of the cancelled investment could be shared for a fee with

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[33] Throughout their briefs, Appellants and supporting amici suggest that the only way for them to recoup their cancelled plants investment is to foist the costs onto captive retail customers. That is incorrect. In recent years, a thriving wholesale electric market has come to life. Some utilities use this market as an outlet for excess plant capacity not needed to serve their retail traditional loads. Other utilities are seeking to build plants expressly for the purpose of serving this interstate wholesale market. See generally Notice of Proposed Rulemaking, "Regulations Governing Independent Power Producers," RM88-4-000 (Federal Energy Regulatory Commission Mar. 16, 1988).

other utilities planning similar projects, or used for internal planning or training purposes. [34]

Appellants may argue that unlike the property in Andrus v. Allard, supra, their $50 million in cancellation costs -- consisting of engineering reports and other allegedly nonproductive assets -- has no salvage or other value whatsoever. Nothing on the record supports that argument. But even assuming the absence of value, that fact is not attributable to Section 1315. Rather, it is attributable to Appellants' voluntary choice to build the kind of plant they built. Had they sought to meet their predicted load through, for example, a series of small power plants, each costing

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[34] Cf., Andrus v. Allard, supra, 444 U.S. at 66 (claimants could exhibit unmarketable avian artifacts for a fee); MacLeod v. Santa Clara County, 749 F.2d 541, 547 (9th Cir. 1984) (denial of right to harvest timber not a taking; affected ranch owner retained the right to, inter alia, continue to hold the property as an invest

$50 million, their cancellation decision might have left them with one completed plant, which now might have market value. Where the utility, not the state, chose the nature of the investment, the utility, not the state, must bear the risk that the result will lack market value.

In short, the Pennsylvania statute does not preclude all beneficial uses of the investment. It precludes only one use: charging captive customers for goods they do not want.

b. Even if Appellants can demonstrate diminution, they cannot blame the statute. To test if the Pennsylvania statute was responsible for Appellants' claimed loss, assume that the statute stated the opposite; i.e., that it did permit recovery from retail ratepayers of the cancellation costs. Would the Appellants then recover the money? Not necessarily. If Appellants raised their price to recover the cancelled

plant costs, customers might reduce their purchases and leave Appellants with lower revenues. [35] Appellants, who bear the burden of proof on this issue, have not established that the statute's denial of recovery rights in fact cost them anything.

In light of this failure of proof, Appellants' argument can succeed only if this Court finds that captive ratepayers have a constitutional duty to buy a product they have not ordered and do not want. That is not, and should not be, the law. See Market St. Railway, supra, 324 U.S. at 567 ("The due process clause ... has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces.").

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[35] See J. BONBRIGHT, A. DANIELSEN, D. KAMERSCHEN, PRINCIPLES OF PUBLIC UTILITY RATES 358 (1988) (discussing "elasticity of demand"). Cf., Market St. Railway v. Railroad Commission, 324 U.S. 548 (1945) (utility not entitled to higher rate where it was not clear customers would pay it).

4. Section 1315, As Applied, Does Not Interfere With Any Distinct, Reasonable, Investment-Backed Expectation

The burden lies on the claimant to demonstrate distinct, reasonable, investment-backed expectations. See Hodel v. Irving, supra, 107 S.Ct. at 2083. As discussed below, Appellants cannot carry that burden.

a. At the time they undertook construction, Appellants had no reasonable basis for assuming that ratepayers would insulate them from economic risk. At the time Appellants undertook to build the plants at issue here, Pennsylvania utility rate doctrine had long held that property not providing current service could not be charged to ratepayers. For example, in City of Pittsburgh v. Pennsylvania Public Utility Commission, 171 Pa. Super. 187, 90 A.2d 607 (1952), the court refused to allow Duquesne to charge ratepayers for a return

either of or on a $708,913 investment in coal property. Despite Duquesne's good intentions, the property "has not been developed, is not presently in use, nor is there evidence that it will be used in the near future." 90 A.2d at 615. Similarly, in Schuykill Valley Lines v. Pennsylvania Public Utility Commission, 165 Pa. Super. 393, 68 A.2d 448 (Pa. 1949), the court noted that "although plans have been drawn for a proposed [office] building, no contracts have been let and the work has been deferred indefinitely due to high construction costs." 68 A.2d at 451-52. The court upheld the Commission's denial of cost recovery since the land "was not property devoted to a public use." 68 A.2d at 452.

The principle articulated in Schuykill -- that a Pennsylvania utility may not recover costs from ratepayers for investments that are not providing current

service to ratepayers -- has been brought forward to this decade in an uninterrupted line of cases. [36]

Appellants had early notice of Pennsylvania's ratemaking policy through direct experience. See Duquesne Light Co. v. Pennsylvania Public Utility Commission, 107 A.2d 745, 752 (Pa. 1954). And in its 1972 retail rate case, just at the time it initiated the investment controverted here, Duquesne was reminded it could recover plant investment (along with a return on that investment) only "when plant is placed in service." Pennsylvania Public Utility Commission v. Duquesne Light Co., 97 P.U.R.3d 227, 256 (Penn. PUC 1972).

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[36] See, e.g., Duquesne Light Co. v. Pennsylvania Public Utility Commission, 107 A.2d 745, 752 (Pa. 1954); cited in Bell Tele. Co. v. Pennsylvania Public Utility Commission, 408 A.2d 917, 926 (Pa. Commw. 1979); cited in West Penn Power Co. v. Pennsylvania Public Utility Commission, 412 A.2d 903 (Pa. Commw. 1980

As is clear from this review, a utility in Pennsylvania in 1972 could expect to recover its investment, and receive a return on it, only by satisfying two tests: (1) completing construction, and (2) placing the plant in service. These tests had been part of the jurisprudence of Pennsylvania for years. [37]

It is unreasonable to expect that the state would have discarded this staple of utility ratemaking -- i.e., investors are responsible for risk prior to property being placed into service -- without saying

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[37] In a 1974 decision, the Pennsylvania Commission again applied the principle in a very real way to one of Appellants. Pennsylvania Public Utilities Commission v. Duquesne Light Co., 5 P.U.R.4th 202 (Penn. PUC 1974). The Commission there denied return (both of and on investment) for certain power plants that had been retired even though not fully depreciated. 5 P.U.R.4th at 206-208. Just as importantly, the Commission denied a return both of and on investment for, among other things, certain "transmission plant constructed in various years but never placed in service...." Id. at 211.

sc expressly. Indeed, the Pennsylvania Supreme Court, in the opinion below, did not discard the precedent; it reiterated the precedent. Specifically, the court found that "fundamental principles of [Pennsylvania's] public utility jurisprudence" prohibited the recovery of costs from ratepayers not associated with the actual provision of present utility service to ratepayers. Barasch v. Pennsylvania Pub. Util. Comm'n, 532 A.2d 325, 338 (Pa. 1987). Section 1315, the court held (id. at 37),

> was mainly an attempt by the 1982 legislature to make clear, by codification, that the above mentioned general principles of utility law should govern the then-ongoing efforts of some electric utilities to recover cancelled plant costs from their customers. (emphasis added)

A different historical policy certainly was not mandated by the Constitution. Ratepayers never have acted as insurers of a utility investment. The Constitution

"has not and cannot be applied to insure values or to restore values that have been lost by the operation of economic forces." Market Street Railway Co., supra, 324 U.S. at 567.

b. Appellants' rendition of pre-construction events does not support their claim that they reasonably expected protection from economic risk. This is not a case where an unwilling utility was ordered to undertake a risky venture and then denied cost recovery for it. Nothing in the events leading up to the construction of the plant supports Appellants' claim that they reasonably could expect protection from the ratemaking risks discussed above.

In the early 1970s, the Pennsylvania Commission had expressed a "concern" about "whether current plans are satisfactory to meet projected future needs for electric power." Investigation of the Need for

Additional Electric Generating and Transmission Facilities, 46 Pa. P.U.C. 23, 25 (1972). At the same time, the Commission recognized that among the "possible changes in conditions which may affect the demand of future power during the next several decades" was the "developing trend to conserve the use of electric service and a moratorium on the promotion of total electric residential living units." Id. That is hardly language mandating power plant construction.

In the same opinion, the Commission articulated a clear division of responsibility between itself and management. In "review[ing] the revised plans of electric utilities," id. at 26, the Commission would act in an oversight capacity only. The plans would be initiated and implemented by the utilities. No state review would occur until the

utility included particular plants in reports filed with the Commission. The Commission's role would be passive; Appellants' role active. [38]

In short, no one told Appellants what strategies to pursue to match capacity with demand, or demand with capacity. Nonnuclear, nonconstruction options were readily available. But Appellants chose the generation option, and they chose the nuclear option. Those choices, while deemed prudent by the Commission, were not without risks. The electric utility industry debate, as to whether or not to respond to the risk of future energy shortages by forever increasing capital expansion, had already begun. [39]

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[38] Contrast West Palm Beach Water Co. v. City of West Palm Beach, P.U.R. 1930A 177 (S.D.Fla. 1928) (aff'g Report of Special Master).

[39] See, e.g., Case and Schoenbrod, Electricity or the Environment: A Study of Public Regulation without Public Control,

That Pennsylvania encouraged Appellants to pursue some response to the predicted gap between demand and capacity does not make Appellants' voluntary decision to build generation, and to build nuclear generation, the decision of the state. Under somewhat different circumstances, this Court has addressed when the actions of a utility can be held to be the responsibility of the state. In Jackson v. Metropolitan Edison Co., 419 U.S. 345 (1974), a customer argued that state approval of the utility's service disconnections made those disconnections were the actions of the state. 419 U.S. at 354-55. This Court disagreed. Approval of utility actions, "where the commission has not put its own weight on the side of the proposed practice by ordering it, does not

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61 CALIF. L. REV. 961, 972 (1973); Lippek, Power and the Environment: A Statutory Approach to Electric Facility Siting, 47 WASH. L. REV. 35, 49 (1971).

transmute a practice initiated by the utility and approved by the commission into `state action.'" Id. at 357.

c. Appellants have not shown they were not compensated for economicy risk. To demonstrate they had a reasonable expectation of freedom from economic risk, Appellants must show they have not been compensated already for that risk. Appellants make no such showing. Nor can they.

Appellants earn a rate of return. That rate of return reflects some type of risk. By asserting that they are insulated from the risk of uneconomic results, Appellants imply that the risk for which the rate of return compensates them is the risk of management imprudence. That cannot be correct. Seminal rate of return cases make clear that in setting a utility's rate of return, there is an assumption of prudent

and efficient management. [40] Ratepayers are never expected to compensate a utility for negligent, wasteful or improvident expenditures; or, by implication, for the risk of such expenditures. [41] The risk of imprudence simply is not a cost that utilities may pass on to their customers. Determining a response to management imprudence is a matter strictly between the utility's investors and the management they hired.

If the risk of imprudence is not compensable through the authorized rate of return, then what risk is reflected in that return? Compensation for the risk of

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[40] See Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944); Bluefield Water Works & Improvement Co. v. Public Service Commission, 262 U.S. 679 (1923).

[41] West Ohio Gas Co. v. Ohio Public Utilities Commission, 294 U.S. 63 (1935); Reagan v. Farmers' Loan and Trust Co., 154 U.S. 362 (1894). See also Missouri ex rel. S.W. Bell Tel. Co. v. Public Service Comm'n, 262 U.S. 276, 290 n.1 (1923) (Brandeis, J., dissenting).

uneconomic results, for one. That risk is a major primary factor in determining the rate of return allowed for utility debt and equity instruments included in the utility's capital structure. [42] Among these economic risks: (a) a nuclear plant might not be licensed to operate due to unresolved safety factors; [43] (b) a particular supply of energy might be rendered unnecessary because of more adequate substitute supplies; [44] and (c) an enterprise might be rendered uneconomic due to the presence of competition; [45] including, by implication, "competition"

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[42] Hope Natural Gas Co., supra, 320 U.S. at 603; Bluefield Water Works, supra, 262 U.S. at 691-93 (1923). Cf., BONBRIGHT, supra at 316, 322-25.

[43] Power Reactor Development Co. v. Electricians, 367 U.S. 396, 415 (1961).

[44] Los Angeles Gas and Electric Corp. v. Railroad Commission of California, 289 U.S. 287, 306 (1933).

[45] Market Street Railway, supra, 324 U.S. at 567.

from consumer conservation, alternative fuels, and other contributors to declining demand.

In short, Appellants have been compensated already for precisely the risk which befell them here. It would be illogical, and unfair, to require consumers to compensate investors for the risk of loss and then to exact the actual loss from consumers should it occur. Jersey Central Power and Light Co. v. FERC, supra, 810 F.2d at 1208-09 (dissenting opinion). [46]

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The foregoing discussion demonstrates that Pennsylvania and federal case law furnished no basis for any reasonable

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[46] That cited passage was not challenged by the majority. See also Washington Gas Light Co. v. Baker, supra, 188 F.2d at 20 ("Ratepayers cannot be required both to carry this risk and to pay the Company for carrying it."). Accord, Petition of Public Service Co. of New Hampshire, No. 87-311, slip op. at 10 (N.H. Jan. 26, 1988).

expectation on Appellants' part that their plant investment would be insulated from economic risk. Moreover, none of the events directly leading to Appellants' investment decision altered this expectation landscape. Only one possible argument remains: that (1) Appellants' initial franchise provided, in return for their agreeing to serve the public, a state promise to insulate them from economic risk; and that (2) such promise amounted to a property right protected by the Fifth Amendment. That argument is directly contradicted by Pennsylvania law. "A certificate of public convenience [to serve the public] is neither a contract nor a property interest under which its holder acquires vested rights." Western Pa. Water Co. v. Commonwealth of Pennsylvania, 10 Pa.

Commw. 533, 311 A.2d 370, 375 (1973). [47]
For these reasons, Appellants' expectations argument must fail.

The facts set forth above are undisputed. Thus this Court has more than ample basis for upholding the Pennsylvania Supreme Court's decision. But if there is a factual dispute (and we do not believe there is one), this Court may not resolve it. The state courts must be the final interpreters of state events and state law.

Keystone, supra, 107 S.Ct. at 1259-60

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[47] See also Snyder v. Pennsylvania Public Utility Commission, 187 Pa.Super. 147, 144 A.2d 468, 470 (1958); Paradise v. Pennsylvania Public Utility Commission, 184 Pa.Super. 8, 132 A.2d 754, 758 (1957); Day v. Public Service Commission, 312 Pa. 381, 167 A. 565, 567 (1933). Cf., Montana Power Co. v. Montana Public Service Commission, 692 P.2d 423 (Mont. 1984) (certificate of convenience and necessity approving plant construction of makes no commitment to any future ratemaking treatment); Iowa-Illinois Gas and Electric Co. v. Iowa State Commerce Commission, 412 N.W.2d 600, 605-06 (Iowa 1987) (same). Compare Kaiser Aetna, supra (government consent to investment created expectation amounting to property right).

(Rehnquist, J., dissenting). [48]

II. THE METHOD FOR ASSIGNING PROSPECTIVELY THE RISK OF UNECONOMIC INVESTMENT IS A MATTER OF POLICY, NOT CONSTITUTIONAL LAW

This Court has held repeatedly that the Constitution does not dictate any particular method of ratemaking so long as the end result is just and reasonable. Moreover, this Court will not "inquire whether the rule applied by the state court is right or wrong, or substitute its own

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[48] While this Court's takings analyses have involved "essentially ad hoc, factual inquiries," Hodel v. Irving, 107 S.Ct. 2076, 2082 (1987) (quoting Kaiser Aetna v. United States, 444 U.S. 164, 175 (1979)) the Court in those cases has not been a fact finder. Rather, the Court has weighed the facts before it, to determine when "'justice and fairness' require that economic injuries caused by public action be compensated." Kaiser Aetna, supra, 444 U.S. at 175 (quoting Penn Central, supra, 438 U.S. at 124). The task of resolving factual disputes has remained with the lower courts. Cf., Hodel v. Irving, 107 S.Ct. 2076, 2084 (1987) (Brennan, J., concurring) (relying on Court of Appeals' finding that negotiations giving rise to plaintiff's property rights had created specific expectations).

view of what should be deemed the better rule, for that of the state court." Demorest v. City Bank Co., 321 U.S. 36, 41-43 (1944).

Deference is particularly important where there exists a multitude of state regulatory agencies determining just and reasonable rates under differing state statutes and policies. New York, for example, allows a return both of and on prudent investment in cancelled plants. New York views this allowance as consistent with the utility's undertaking the obligation to serve. [49] Other states permit recovery of, but not return on, the amounts invested in the cancelled plant. They view the ratepayer-investor relationship as a joint venture which

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[49] See, e.g., Rochester Gas and Elec. Corp., 45 P.U.R.4th 386 (NY PSC 1982).

requires a sharing of risks and costs. [50] Still other states permit a return of investment, but limit such return to the cost of long-term debt (thus denying a return on equity). These states reason that while equity investors have a say in the management of the utility, holders of debt do not; therefore, the latter group should not be held responsible management's uneconomic decisions. [51]

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[50] See, e.g., Atlantic City Elec. Co., 51 P.U.R.4th 109 (N.J.Bd. of P.U. 1983); Bangor-Hydro Elec. Co., 46 P.U.R. 503 (Me. PUC 1982).

[51] See, e.g., Carolina Power and Light Co., 49 P.U.R. 4th 188 (N.C. Util. Comm'n 1982); Potomac Elec. Power Co., 50 P.U.R.4th 500 (D.C. PSC 1982). For a review of plant cancellation decisions, see generally Sommers, Recovery of Electric Utility Losses from Abandoned Construction Projects, 8 WM. MITCHELL L. REV. 363, 371, n.43 (1982); Wilson, Ratemaking Treatment of Abandoned Generating Plant Losses, 8 WM. MITCHELL L. REV. 343, 352-358 (1982). See also Cleaves, Constitutional Protection for the Utility Investor: The Confiscation Doctrine after Cleveland Electric Illuminating Co. v. Public Utilities Commission of Ohio," 12 B.C.L. ENVTL. L. REV. 527 (1985).

Recoupment of all or part of a return of and on and investment is not a universal policy, however. In Oregon and other states, recovery of cancelled plant costs is forbidden by statute. [52] These states have opted for a regulatory scheme that imposes the entire risk of non-operational plant on investors. Still other states have barred the passthrough to ratepayers of cancelled plant costs, but require explicit compensation for investors undertaking this risk of non-operation. [53]

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[52] See, e.g., Pacific Power & Light Co., 49 P.U.R.4th 82 (Or. PUC 1982); Portland Gen. Elec. Co., 49 P.U.R.4th 274 (Or. PUC 1982). Accord, Pacific Power and Light Co., 53 P.U.R.4th 24 (Mont. PSC 1983); Lower Valley & Light, Inc., No. 9617-sub 11, at 9 (Wyo. PSC Dec. 2, 1982) (denying recovery for the cancelled WPPSS 4 and 5 and the Pebble Spring plants).

[53] Compare Office of Consumers' Counsel v. Public Utilities Commission, 67 Ohio St. 153, 423 N.E.2d 820 (1981) (denial of recovery mandated by statute), appeal dismissed, 455 U.S. 914 (1982); with Office of Consumers' Counsel v. Public Utility Commission, 4 Ohio St. 3d 111, 115, 447

A final ratemaking option is to eschew establishing a doctrine involving the "up-front" allocation of risk. Instead, a a post-construction review would apportion cancellation costs in some fashion determined to be "just and reasonable." This option is consistent with this Court's holding in Hope Natural Gas, supra: [I]t is the result reached not the method employed which is controlling." 320 U.S. at 602. [54]

This Court should not supersede this rich variety of approaches to risk

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N.E.2d 749, 753-54 (1983) (approving commission's subsequent action raising utility's rate of return due to increased risk resulting from the cost recovery decision). Accord, Washington Utils. & Trans. Commission v. Pacific Power and Light Co., 52 P.U.R.4th 148 (Wash. UTC 1983).

[54] Of course, if there was no clear risk allocation rule determined in advance of construction, the authorized rate of return during construction would have to reflect the uncertainty over the later risk allocation.

assignment by imposing a single ratemaking method under the guise of constitutional construction. As discussed in Part I.A, supra, the Constitution requires only that the rate methodology not conflict with distinct, reasonable, investment-backed expectations. In the utility regulatory arena, whether such a conflict occurs may depend on specific expectation-creating events like Commission orders, utility proposals, or the absence of such orders and proposals. These events will vary in each regulatory jurisdiction.

Amicus Pennsylvania Electric Association ("PEA") concedes that "there are several methods of ratemaking that, at least in theory, would fully protect the ultimate constitutional interest," Br. at 23, and that "any standard that fairly balances the benefits and burdens of regulation can satisfy constitutional standards," id. at 17 n.13. Yet PEA

instead would impose a single standard, the "prudent investment" standard, as a matter of constitutional doctrine. PEA cites no authority for the principle that this approach is the "appropriate ... constitutional benchmark." No such authority exists.

The prudent investment standard has been rejected as illogical, let alone as constitutionally-imposed doctrine. Specifically, the standard misconstrues the purpose of excluding nonoperational plant from rates. The various methods cited above are means of allocating risk; they are not methods of punishing a "culpable" party. As the Pennsylvania Commission noted, where a utility overbuilt capacity:

> [T]he fact that excessive plant investments were prudent when made does not necessarily preclude the Commission from allotting responsibility for their cost....The sudden burden of this new plant investment was no fault of Penn Power of its investors; but neither was it the fault of the

ratepayers.

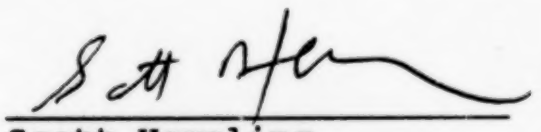
Philadelphia Electric Co. v. Pennsylvania Public Utility Commission, 37 P.U.R.4th 381, 387 (Penn. PUC 1980). Where, by assumption, no one is at fault, it is illogical to assign costs based on the absence of fault. But that is exactly what the prudent investment approach does.

The prudent management approach fails on a policy level as well. By focusing narrowly on the prudence of the decision to build, the prudent investment policy weakens any incentive to improve management processes. Ratepayers and the public at large, benefits from (1) accurate demand forecasting; (2) precise determinations of the type and timing of new capacity needs; and (3) meaningful review of ongoing construction. If rates are based only on whether utility management is imprudent or is acting in bad faith, little if any economic incentive will exist for

management to produce these important benefits.

CONCLUSION

WHEREFORE, for the foregoing reasons, Amici respectfully request this Court to affirm the decision below.



Scott Hempling
Counsel of Record
Environmental Action
Foundation
1525 New Hampshire Ave.
Washington, DC 20036

Roger Colton
72 Maple St.
Belmont, MA 02178

June 30, 1988

CERTIFICATE OF SERVICE

I hereby certify that on June 30, 1988, I served a copy of the foregoing document on those persons listed below, by depositing the appropriate number of copies thereof in the United States mail, postage prepaid, or by equivalent method of service:

William E. Zeiter, Esq.
Morgan, Lewis & Bockius
2000 One Logan Square
Philadelphia, PA 19103

Irwin A. Popowsky, Esq.
Office of Consumer Advocate
1425 Strawberry Sq.
Harrisburg, PA 17120

Bohdan R. Pankiw, Esq.
Pennsylvania Public Utility Commission
P.O. Box 3265
Harrisburg, PA 17120

Scott Hempling

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No. 87-1160

IN THE
Supreme Court of the United States
OCTOBER TERM, 1987

DUQUESNE LIGHT COMPANY

and

PENNSYLVANIA POWER COMPANY,
Appellants,

v.

DAVID M. BARASCH,
CONSUMER ADVOCATE, *et al.*,
Appellees.

On Appeal from the Supreme Court of Pennsylvania

BRIEF OF INDUSTRIAL ENERGY CONSUMERS OF PENNSYLVANIA; ELECTRICITY CONSUMERS RESOURCE COUNCIL AND AMERICAN IRON AND STEEL INSTITUTE AS AMICUS CURIAE IN SUPPORT OF APPELLEES

HENRY R. MACNICHOLAS
H. LEE ROUSSEL
DAVID M. KLEPPINGER *
MCNEES, WALLACE & NURICK
100 Pine Street
P.O. Box 1166
Harrisburg, PA 17108-1166
(717) 232-8000
Attorneys for Industrial Energy Consumers of Pennsylvania, Electricity Consumers Resource Council and American Iron and Steel Institute

* Counsel of Record

June 30, 1988

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

QUESTION PRESENTED

Do the Fifth and Fourteenth Amendments require state ratemaking agencies to allow recovery of or the return on prudently incurred investments (including but not limited to cancelled electric generating units) without consideration of whether those investments constitute used and useful utility property?

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IN THE

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DUQUESNE LIGHT COMPANY

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DAVID M. BARASCH,
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Appellees.

On Appeal from the Supreme Court of Pennsylvania

BRIEF OF INDUSTRIAL ENERGY CONSUMERS OF PENNSYLVANIA, ELECTRICITY CONSUMERS RESOURCE COUNCIL AND AMERICAN IRON AND STEEL INSTITUTE AS AMICUS CURIAE IN SUPPORT OF APPELLEES

The Industrial Energy Consumers of Pennsylvania (IECPA), the Electricity Consumers Resource Council (ELCON), and the American Iron and Steel Institute (AISI) hereby submit their Brief Amicus Curiae in Support of Appellee David M. Barasch, Consumer Advocate, et al. and of the decision by the Supreme Court of Pennsylvania.[1]

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[1] IECPA, ELCON and AISI have obtained the written consents of all parties to this case. The written consents have been filed with the Clerk of this Court.

INTEREST OF AMICUS CURIAE

IECPA is a statewide group of energy intensive industrial consumers of electricity.[2] IECPA members employ approximately 130,451 Pennsylvanians and consume 25% of the industrial electricity purchased in the Commonwealth. IECPA members operate 187 facilities in Pennsylvania, including several within the service territory of the Appellants, Duquesne Light Company and Pennsylvania Power Company.

[2] The members of IECPA are:

Air Products & Chemicals, Inc.
Airco Industrial Gases
Allegheny Ludlum Steel Corporation
Allentown Cement Company
Allied Corporation
Appleton Papers, Inc.
Armco Advanced Materials Corporation
Babcock & Wilcox Company
The J. E. Baker Company
Bethlehem Steel Corporation
Cabot Corporation
Carpenter Technology Corporation
Caterpillar Tractor Company
Cooper Industries
Corning Glass Works
Cressona Aluminum Company
Dana Corporation
Franklin Steel Company
General Battery Corporation
International Paper Company
Hercules Cement Company
Hershey Foods Corporation
Jessop Steel Company
Liquid Air Corporation
Lukens Steel Company
M G Industries
National Forge Company
New Jersey Zinc Company, Inc.
Owens-Illinois, Inc.
PPG Industries, Inc.
The Procter & Gamble Paper Products Co.
Rohm and Haas Company
Standard Steel
Sun Refining & Marketing Company
Union Carbide Corporation
USX Corporation
Washington Steel Corporation

ELCON is a national organization of 17 energy intensive industrial consumers of electricity which employ more than 800,000 people. ELCON members operate more than 650 different facilities in 49 of the 50 states and, in addition, have sizeable operations in numerous foreign countries. The electricity consumption by ELCON members exceeds the total electricity sales of 36 of the 50 states. ELCON member companies produce a wide range of products, including steel, chemicals, industrial gases, glass, motor vehicles, electronic equipment, appliances, textiles and food.[3]

AISA is the principal trade association of the domestic steel industry. Its forty-three domestic member companies account for more than eighty percent of the raw steel production capability in the United States.[4] The

[3] The members of ELCON are:

Air Products and Chemicals, Inc.
American National Can
Anheuser-Busch Companies, Inc.
Armco
Bethlehem Steel Corporation
Cone Mills Corporation
Corning Glass Works
Dow Chemical U.S.A.
E.I. duPont deNemours & Company
FMC Corporation
General Motors Corporation
Hercules Incorporated
Hershey Foods Corporation
Owens-Corning Fiberglass
PPG Industries, Inc.
A. E. Staley Manufacturing Company
Union Carbide Corporation

[4] The domestic member companies of AISI are:

Acme Steel Company
Armco Inc.

cost of electricity to AISI members may constitute as much as forty percent of the cost of a steel mill product,

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Atlantic Steel Company
Avesta Stainless Inc.
The Babcock & Wilcox Company
Bethlehem Steel Corporation
Berg Steel Pipe Corporation
California Steel Industries, Inc.
Carpenter Technology Corporation
Cleveland-Cliffs Inc.
Copperweld Steel Corporation
Electralloy Corporation
A. Finkl & Sons Co.
Geneva Steel Company
Georgetown Industries, Inc.
Gulf States Steel, Inc.
M. A. Hanna Company
Harsco Corporation
Hi Specialty America
Inland Steel Industries, Inc.
Earle M. Jorgensen Company
Laclede Steel Company
Lone Star Technologies, Inc.
LTV Steel Company
Lukens Inc.
McLouth Steel Products Corporation
National Steel Corportaion
North Star Steel Company
Oblebay Norton Company
Raritan River Steel Company
Rhode Island Forging Steel, Inc.
Rome Strip Steel Company, Inc.
Rouge Steel Company
Sandvik Inc.
Sharon Steel Corporation
Sharon Tube Company
Shenango Incorporated
The Timken Company
USS, A Division of USX Corporation
Valley-Vulcan Mold Company
Weirton Steel Corporation
Wheatland Tube Company
Wheeling-Pittsburgh Steel Corporation

making the steel industry one of the most energy-intensive industries in the country.

Individual IECPA, ELCON and AISI members, either directly or through industrial intervention groups, have participated in numerous rate cases filed by utilities over the last fiifteen years, including cases in which the issue of a return of or on prudent investments, which have not proven to be used and useful for producing electric service, has been addressed. In no such case has the utility been entitled to a return of or on its investment as a matter of right. Rather, the respective state or the ratemaking agency of the state has always had the discretion to determine whether the utility is entitled to a return of or on prudent investment based on all the facts presented, including whether the investment produced used and useful property.

IECPA, ELCON and AISI have a direct and substantial interest in this case. Each organization seeks to assure that adequate and secure long-term supplies of electricity will be available in Pennsylvania and the nation at equitable and competitive prices. However, the development of equitable and competitive prices for electricity service to ratepayers must be based upon valid cost of service principles. IECPAs, ELCON's and AISI's interests are twofold in that their members must have long-term supplies of electricity available in order to produce their respective products. However, the assurance of a long-term supply of electricity must be at a price which enables their members to produce competitively priced products. An excessive supply of electricity at excessive prices will not permit their members to maintain their competitive positions in the marketplace.

The position advocated by the Appellants and the amicus curiae supporting the Appellants would create a constitutional entitlement to the recovery of or the return on any prudent investment made by an electric

utility without consideration of whether that investment resulted in used and useful public utility property providing actual utility service to customers. It would eliminate the flexibility and discretion which states have had to decide whether a utility should be permitted to recover a return of or on investments which may have been prudent but which have not produced used and useful property. The retention of that flexibility and discretion is essential to the proper balancing of ratepayer and shareholder interests. Appellants seek to establish a constitutional right for utilities to recover a return of and on investments which a private enterprise in the competitive marketplace would have no such opportunity to recover. Thus, the principle that regulation "mirror" the operation of competitive markets would be shattered.

Removal of the "used and useful" standard, as advocated by Appellants and their amici would create a "prudence-only" standard for the recovery of or on utility investment. As members of energy intensive industrial intervention groups, IECPA, ELCON and AISI members have participated regularly in a substantial number of rate cases filed by utilities over the last fifteen years. That experience confirms their serious concerns with a prudence-only standard because one of the few checks state ratemaking agencies have been able to apply on utility rate increases is the requirement that a prudent utility investment should also result in the production of used and useful utility property. A "prudence-only" standard would remove this check. Under current law, if a prudent investment fails to produce used and useful utility property, a state has discretion to deny a return of or on that investment. States require such discretion to properly balance the interests of utilities and consumers. A constitutional entitlement to the recovery of or on all prudent utility investment could cause greater rate increases than are necessary or appropriate to fairly compensate utility investors. Such increases would, of course, be contrary to the public interest.

The argument set forth below will show that the Pennsylvania Public Utility Code, as applied to Appellants in this case, has not effected a taking of property in violation of the Fifth and Fourteenth Amendments to the Constitution.

COUNTERSTATEMENT OF THE CASE

IECPA, ELCON and AISI adopt the counterstatement of the case as set forth in the Brief of Appellee David M. Barasch, Consumer Advocate.

However, IECPA, ELCON and AISI must clarify the mischaracterizations by Appellants and their amici of two decisions by the Pennsylvania Public Utility Commission: *Investigation of the Need for Additional Electric Generating and Transmission Facilities,* Investigation Docket No. 138, 46 Pa. P.U.C. 23 (1972), and *Pennsylvania Public Utility Comm'n v. Metropolitan Edison Co.,* Rate Investigation Docket No. 64, 47 Pa. P.U.C. 56 (1973). Neither of these decisions imposed an affirmative requirement on the Appellants, or any other jurisdictional electric utility in Pennsylvania, to invest in additional electric generating stations.

The Commission instituted Investigation Docket No. 138 due to the threat of electric power shortages and the need to stimulate electric power companies "in the development of plans for increasing generating capacity to meet anticipated load growth and future demands." 46 Pa. P.U.C. at 23. The investigation was necessitated because load growth had exceeded certain utility companies' inaccurate forecasts and because a "conservative attitude" on the part of some utilities resulted in a serious installed capacity deficiency situation. *Id.* at 24.

However, as the Commission sought to rectify the problem, it specifically left to each utility the determination of whether that specific utility needed additional capacity. It left to each utility the estimates of customer demand

requirements on which any determination of need for additional capacity would be based. The Commission also clearly left to each utility company the decision as to whether sufficient reserve capacity should be achieved through new construction, the importation of electricity from other sources, or from conservation.[5] In the event a specific utility concluded it needed additional capacity based on its estimates of consumer demand and its evaluation of the alternatives available for meeting that demand, the Commission also left to each utility the development of a generating capacity expansion plan, including the schedules for generating plant and transmission line additions, and the cost estimates for construction of new generating plants. *See* Ordering Paragraphs at 46 Pa. P.U.C. at 26-27.

The Commission never directed or required the Appellants to develop, plan for, or invest in the four cancelled nuclear plants at issue in this case. The most the Commission ever indicated to the utility industry as a whole was that it "wanted 2,000 megawatts of combustion turbine capacity immediately." *Id.* at 25. After the Commission's investigation, the Appellants, based upon their own projections of capacity needs, load growth, and the effect of conservation, chose to pursue the capacity planning schedule which resulted in the planning and cancellation of the four nuclear units in this case. The Commission never "required" the Appellants to construct the facilities which are the subject of this case.

In the context of rate relief requests by individual utilities in the early 1970s, the Commission continued to indicate its desire for specific individual utilities to continue construction of electric generating capacity where necessary. *See e.g., Pennsylvania Public Utility Comm'n*

[5] Even as early as this 1972 investigation, the Commission noted the developing trend to conserve the use of electricity and the implications that such conservation would have on the demands for electric power. 46 Pa. P.U.C. at 26-27.

v. Metropolitan Edison Co., Rate Investigation Docket No. 64, *supra*. However, these Commission desires were expressed in the context of base rate increase requests by specific utilities after such utilities had already made their decision to invest in the construction of generating capacity based upon their own specific capacity plan forecasts and specific load growth estimates. As individual utilities approached the Commission for rate relief, one reason relied on by the Commission in granting the requested relief was the Commission's distinct concern with the sufficiency of the electric generating capacity in the Commonwealth. *Id* at 59. The Commission did not, however, in *Metropolitan Edison* or in any other rate case actually require a utility to engage in a particular capacity expansion plan or to construct a particular type of capacity. Furthermore, in no rate proceeding involving Appellants did the Commission endorse the construction program resulting in the cancelled plants at issue here.

A review of the Pennsylvania Public Utility Code, 66 Pa. C.S. § 101, *et seq.* (hereinafter "Code") indicates that the Pennsylvania Public Utility Commission does not have the statutory authority to require investment in generating plants. The Code merely establishes that every public utility must furnish and maintain adequate, efficient, safe, and reasonable service and facilities. 66 Pa. C.S. § 1501. Thus, the decision by the Appellants to pursue the capacity expansion plan in question constituted a voluntary act on their part based upon their own respective capacity plan forecasts and load growth scenarios. Any references by the Appellants, or the amici supporting Appellants, to the proposition that the Commission required the investments subject to this case should be ignored.

SUMMARY OF ARGUMENT

The Fifth and Fourteenth Amendments to the United States Constitution do not require states to allow recovery of or on prudently incurred investments by regulated utilities without any consideration of whether those investments produced used and useful utility property. Section 1315 of the Pennsylvania Public Utility Code, which denies recovery of or on an investment which is not used and useful, is consistent with this Court's application of the Fifth and Fourteenth Amendments to regulated industries in the line of cases proceeding from *Smyth v. Ames*, 169 U.S. 466 (1898) through *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) to *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968).

By creating a constitutional entitlement to utility investor recovery of or on prudent investment in property which does not produce used and useful public service, this Court would upset the long-established principle of public utility regulation that regulation should mirror the competitive private marketplace in an otherwise monopolistic business. IECPA, ELCON and AISI members compete in the private economy and are well aware of its competitive nature. The United States economy is organized on the decentralized lines of private property and private enterprise such that competition is relied upon to promote the public welfare and the market is the central institution regulating economic activity.[6] However, in some industries, like the electric utility industry, competition has not traditionally been effective and regulation by the government may be necessary to protect the public interest. As noted by Walter Adams, "Here the visible hand of public regulation was to replace the invisible hand of Adam Smith in order to protect consumers against extortion of charges, restrictions of output,

[6] Charles F. Phillips, Jr., *The Regulation of Public Utilities* (1984).

deterioration of service, and unfair discrimination."[7] In the private unregulated economy, the invisible hand of the market usually does not provide a return of, or on, investments, however prudent, which turn out to be wrong by not producing property which is used and useful in making products or services consumers wish to purchase. Competition prevents non-monopolists from raising their prices above those of their competitors who did not make comparable investments. The visible hand of public regulation should not provide an affirmative constitutional entitlement to the recovery of such prudent, yet uneconomic, investments.

Such an entitlement would create an undue preference for the utility investor over the investor in the private competitive marketplace. It would not only shift the balance in favor of the utility investor over the ratepayer and the private investor, but would also upset the balance inherent in the American economy between regulated entities and nonregulated entities. The former would recover *any* prudent investment, with the cost of prudent but uneconomic investment borne by their customers and not by their shareholders. Competitive private enterprises have no such guarantee and the cost of their prudent, yet uneconomic investments are usually borne entirely by their shareholders. No rational reading of this Court's teachings in the *Hope* and *Permian Basin* cases would conclude that this Court intended the former as a result.

During the Court's application of the Fifth and Fourteenth Amendments to regulated industries in the context of these three cases, the utility investor has never been granted a constitutional entitlement to the recovery of all prudent investments without a consideration of other relevant factors. Those factors include, but are not limited to, the ability of the utility to maintain its finan-

[7] Walter Adams "The Role of Competition and the Regulated Industries", 48 American Economic Review, 527 (1958).

cial integrity, the ability of the utility to attract necessary capital, fair compensation to investors for the risks they have assumed, and protection of the relevant public interest both at the present time and in the foreseeable future. *Permian*, 390 U.S. at 792. These factors are evaluated in the context of the total rate case effect of the state ratemaking body's decision and the end result of that case. *See Hope*, 320 U.S. at 602-603.

No constitutional taking of property can exist when the total rate case effect and the end result of that case permits the utility to operate successfully and profitably. Such a result indicates that a proper balancing has been achieved between the interests of ratepayers and investors consistent with this Court's teachings in *Hope*, *Permian Basin*, and *FPC v. Memphis Light, Gas & Water Division*, 411 U.S. 458 (1973). Not only have Appellants continued to operate successfully and profitably, but each has continued to engage in a substantial construction program after the Pennsylvania Supreme Court's decision to deny a recovery of or on the prudently incurred investment in cancelled nuclear generating units.

The Appellants and the amici supporting Appellants misinterpret and misapply the intent and teachings of the *Hope* and *Permian Basin* cases. In those cases, this Court did not create an additional constitutional right guaranteeing a recovery of or on all prudent investments made by utility investors. Rather, those cases sought to remove the courts from intervention in the minutia of regulatory rate case proceedings and to have courts focus, instead, on the issue of whether the regulatory decision permitted the utility to operate successfully. If this end result is obtained, then a utility should not have a complaint because the interests of ratepayers and investors have been reasonably balanced.

This Court's dismissal of comparable proceedings indicates that the used and useful principle as applied by the

Pennsylvania Supreme Court was not overridden by *Hope* and that utility investors have no constitutional right to the recovery of or on all prudent investments.

Through a dismissal for want of a substantial federal question, this Court refused to reverse on the merits Pennsylvania and other states' denial of cost recovery on utility investment in nuclear power plants which have been out of service for extended periods due to nuclear accidents. *Pennsylvania Electric Co. v. Pennsylvania Public Utility Comm'n*, 509 Pa. 324, 502 A.2d 130 (1985), *appeal dismissed sub nom. Metropolitan Edison Co. v. Pennsylvania Public Utility Comm'n*, 476 U.S. 1137 (1986). *See also Jersey Central Power & Light Co. v. Board of Public Utilities*, 466 U.S. 947 (1984). The Court dismissed several other cases, some of which involved the same cancelled nuclear plants subject to this case. *Cleveland Electric Illuminating Co. v. Public Utilities Comm'n*, 4 Ohio St.3d 107, 447 N.E.2d 746, *appeal dismissed*, 464 U.S. 802 (1983); *Cleveland Electric Illuminating Co. v. Public Utilities Comm'n*, No. 82-165 (Ohio, July 7, 1982), *appeal dismissed*, 459 U.S. 1094 (1983); *Office of Consumers' Counsel v. Public Utilities Comm'n*, 67 Ohio St.2d 153, 423 N.E.2d 820 (1981), *appeal dismissed sub nom, Cleveland Electric Illuminating Co. v. Office of Consumers' Counsel*, 455 U.S. 914 (1982); *Northern Indiana Public Service Co. v. Citizens Action Coalition of Indiana, Inc.*, 485 N.E.2d 610 (Indiana 1985), *appeal dismissed* and *cert. denied*, 476 U.S. 1137 (1986).

Therefore, no basis exists in the context of economic theory, in this Court's teachings in *Hope* and *Permian Basin*, or in this Court's treatment of similar issues, to create a constitutional entitlement for the recovery of or on all prudent utility investments irrespective of whether those investments ever produced used and useful utility property.

ARGUMENT

I. The Pennsylvania Supreme Court's Application of The Used And Useful Principle Did Not Result In An Unconstitutional Taking Of The Appellant's Property Because The Fifth And Fourteenth Amendments Do Not Entitle Regulated Utilities To Recovery Of Or On Prudently Incurred Investments Without Consideration Of Other Factors, Including, But Not Limited To, The Used And Useful Principle.

Section 1315 of the Code reads as follows:

> § 1315. Limitation on consideration of certain costs for electric utilities
>
> Except for such nonrevenue producing, nonexpense reducing investments as may be reasonably shown to be necessary to improve environmental conditions at existing facilities or improve safety at existing facilities or as may be required to convert facilities to the utilization of coal, the cost of construction or expansion of a facility undertaken by a public utility producing, generating, transmitting, distributing or furnishing electricity shall not be made a part of the rate base nor otherwise included in the rates charged by the electric utility until such time as the facility is used and useful in service to the public. Except as stated in this section, no electric utility property shall be deemed used and useful until it is presently providing actual utility service to the customers. 66 Pa. C.S. § 1315.

The Pennsylvania Supreme Court held that Section 1315 of the Code prohibits an electric utility from recovering the costs of cancelled plants from ratepayers, either by making such costs part of its rate base or by converting them into operating expenses through amortization. To have reached any other conclusion, the Pennsylvania Supreme Court would have had to treat as surplusage the portion of Section 1315's proscription which states, ". . . nor otherwise included in the rates charged by the

electric utility." *Barasch v. Pennsylvania Public Utility Comm'n*, 532 A.2d at 332. Section 1315 specifically defines "used and useful" as property which is presently providing actual utility service to customers. As a result, investment in a cancelled plant which never provided actual utility service had to be excluded from rate base and not charged to ratepayers through an amortized operating expense. Clearly, the Pennsylvania Supreme Court applied the letter of the law to the Appellants consistent with Section 1934 of the Statutory Construction Act of 1972, 1 Pa. C.S. § 1934. *Id.* at 332.

Appellants now challenge the constitutional validity of the statute itself, as well as other "unspecified ratemaking legislation."[8] In order for that constitutional challenge to be successful, this Court would have to find that the Fifth and Fourteenth Amendments *require* states to allow recovery of or on prudently incurred investments (including, but not limited to, cancelled electric generating units) without any consideration of whether those investments constitute used and useful property. The establishment of such a constitutional entitlement to the recovery of all prudent investments would be directly contrary to the economic rationale underlying utility rate regulation and in direct contravention of this Court's definition of the rights of utility investors.

A. *Appellants' Interpretation Of Hope And Permian Basin Violates The Basic Economic Tenets of Regulatory Law Which Are Intended To Mirror The Competitive Marketplace.*

Rate regulation is, in theory and in practice, hopefully, the substitute for competition. *Jersey Central Power & Light v. FERC*, 810 F.2d 1168, 1190 (D.C. Cir. 1987)

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[8] *See* Appellant's Brief at pp. 2-3, footnote no. 2, for an explanation of this term.

(Starr, concurring). Appellant's interpretation of *Hope* and *Permian Basin* creating a prudence-only standard would prevent regulation from properly substituting for competition. In a competitive marketplace, investors have no constitutional entitlement to a return of or on prudent investments which fail to produce economic results. If rate regulation is performing its function as a substitute for competition, the regulated entity, likewise, should not be afforded a constitutional entitlement to a return of or on prudent investments which never provide an economic benefit to ratepayers. *Id.* at 1190. Judge Starr's characterization of rate regulation as a substitute for competition and his caution to examine both ends of the continuum—both the prudence of the investment and whether the end result of the investment was used and useful—forms the crux of this amicus curiae brief in opposition to the prudence-only standard advocated by Appellants and the amici supporting Appellants.

The used and useful principle operates as a restraining principle, reminding utility managers that they must assume the risk of economic forces working against an investment which is prudent at the time it is made. 810 F.2d 1190, fn.1. Without this "reminder" to utility managers, no meaningful check would exist on managers' decisions to plan and build excess generating capacity and automatically pass the costs of that capacity on to ratepayers. While prudence is a relevant issue in the process of striking a reasonable balance in rate setting for public utilities, the used and useful rule is another safeguard. The prudence rule looks to the time of the investment, whereas the used and useful rule looks to a later time. These two principles are designed to assure that the ratepayers, whose property might otherwise be taken by regulatory authorities through approval of utility rate increases, will not necessarily be saddled with the results of management's defalcations or mistakes, or as a matter of simple justice, be required to pay for that

which provides the ratepayers with not discernible benefit. *Id.* at 1190.

Without application of the used and useful principle to offset the application of the prudence standard, the Constitution would protect utility investors entirely from the business risks experienced daily in the free market system. These business risks are a component of the ratemaking process when regulatory bodies establish an authorized overall rate of return for the utility. A business in the private sector must constantly deal with the risk of investing in too much capacity when the market does not meet expectations due to economic factors beyond management's control. Absent a monopoly, a private business cannot automatically increase prices to its customers to recover a prudent but uneconomic expenditure, since customers will switch to competitors' products. IECPA, ELCON and AISI are in full agreement with Judge Starr's statement that utilities should not be exempt from comparable competitive economic forces. *Id.* at 1191.

In the private competitive marketplace, prudence does not guarantee a company economic success or a return of or on its investment. Numerous private "prudent" companies have gone bankrupt because of investments which were prudent when made but which turned out to be poor business or economic decisions. The regulatory system already provides some relief to utilities from the threat of bankruptcy for making uneconomic business decisions. This Court should not ignore economic reality and entitle utility investors to a return of or on investment which does not produce used and useful utility property. If such an investment were made in the private sector, no such entitlement of a return would exist. Individual members of IECPA, ELCON and AISI constantly make prudent business decisions with the expectation that the decision will represent a valid economic and business judgment. Unfortunately, investments do not always

achieve their desired expectations and shareholders must absorb any resulting economic loss. This Court should not place utility investors in a protective cocoon which insulates them from valid business risks experienced by unregulated entities.

Moreover, denial of recovery of a prudent investment not used and useful for service to customers does not constitute a taking of property by the state. No property is taken since the private competitive marketplace itself denied any return. No property right exists entitling a regulated utility to recovery in excess of that provided in the private, competitive, unregulated economy. *Market Street Railway Co. v. Railroad Comm'n of Calif.*, 324 U.S. 548, 566-67 (1945) (recovery not required where market forces, not the state, reduces the value of property). Here, Appellants' prudent investments were rendered uneconomic, and the plants cancelled, as a result of market forces, not state action. Pennsylvania's decision to deny Appellants a recovery of or on property that was not used and useful merely confirmed the operation of market forces. The purposes of regulation is to deny utilities monopoly profits in excess of that which a competitive marketplace would permit. Here, Appellants attempt to manipulate the regulatory system and this Court's prior decisions to compel a recovery in excess of that which a competitive economy would allow. This Court should not be manipulated so as to create a constitutional standard which would mandate the potential of monopoly profits for the utility industry far in excess of what could be earned in the competitive marketplace.

B. *The Decisions By This Court And The Lower Federal Courts Before And After The Hope And Permian Cases Confirm That The Continued Utilization Of The Used And Useful Principle In Ratemaking Is Consistent With This Court's Holdings In Hope And Permian.*

The Appellants and amici supporting Appellants rely upon a misapplication of this Court's teachings in the *Hope* and *Permian Basin* cases. Neither case held that utility investors have a constitutional entitlement to the recovery of all prudent investments without any consideration of the used and useful principle. Appellants seek to distort the Court's holdings in these cases by ignoring the "end result" of the case and by overturning the Court's opinion that "It is not theory but impact of the rate order which counts." *Hope*, 320 U.S. at 602.

Hope and *Permian Basin* clarified the Court's approach to utility rate cases and utility investor expectations but did not override or overturn the used and useful principle. In fact, *Hope* did not discuss the used and useful principle when outlining this Court's application of the "just and reasonable" ratemaking standard.

In *Hope*, the Court refused to bind the Federal Power Commission to the use of any single formula or combination of formulae in determining rates primarily because the ratemaking function involved the making of pragmatic adjustments. 320 U.S. at 602; *see also FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575 (1942). When a ratemaking order is challenged in the courts, the question under *Hope* is whether the order "viewed in its entirety" meets the requirements of the statutory standard of "just and reasonable rates." The result which is obtained is the important factor and not the method employed in reaching that result. *Id.* The Appellants and supporting amici in this proceeding would have this Court focus entirely on one ratemaking item in a com-

plex rate proceeding which achieved the all important *result* of just and reasonable rates.

In both *Hope and Permian Basin*, the Court held that if the total effect of the rate order cannot be said to be unjust and unreasonable, then judicial inquiry should end. Even if the methods employed to reach a certain result contain infirmities, the Court would not necessarily conclude that the total effect of the rate order was inappropriate. *Id.* The total effect of the rate order subject to this appeal on Duquesne Light Company resulted in an 11.6% overall rate of return, a 16.14% return on common equity, an annual base rate increase in excess of $105 Million, and total annual revenues in excess of $800 Million. (App. 19C, 93C, 126C). For Duquesne Light Company to contend that the disallowed $3.5 Million annual amortization for the cancelled plant costs violated this Court's teachings in *Hope* borders on the ridiculous. While *Hope* recognized the fixing of just and reasonable rates involves a balancing of the investor and consumer interests, the Duquesne Light Company investor interests in financial integrity were clearly served even with the $3.5 Million annual amortization disallowance.

The *Hope* court stated, "Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid even though they might produce only a meager return on the so called 'fair value' rate base." 320 U.S. at 605. Duquesne Light Company continues to operate successfully, has maintained its financial integrity, its ability to attract capital and has sufficiently compensated its investors after the Pennsylvania Supreme Court disallowed a return of and on its prudent investment in cancelled generating plant. Therefore, all tests as stated in *Hope* have been met and this Court should refrain from establishing an additional constitutional entitlement for those utility investors to recover all prudent investment automatically without a treatment of the other factors stated in *Hope*.[9]

While the *Hope* court established the above criteria, it did not reject the used and useful doctrine or forbid its use by states or their ratemaking agencies when balancing the interests of utility ratepayers and investors. Contrary to the assertions of the amici supporting the Appellants, the "used and useful" doctrine did not disappear or become unnecessary as a result of *Hope*. It remained as a valid criteria for each state and each ratemaking agency to consider when performing the balancing of interests mandated by *Hope*. The lower federal and state courts have continued to apply the used and useful doctrine and this Court continues to dismiss appeals challenging its constitutionality. *See* Part II below.

Similarly, in the *Permian Basin Area Rate Cases*, cited so favorably by the Appellants and the supporting amici, this Court never rejected the concept of the used and useful principle. The Court merely clarified and elaborated upon the *Hope* end result test by stating that the reviewing court must determine whether the rate order may be reasonably expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the *relevant public inter-*

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[9] The other Appellant, Pennsylvania Power Company (Penn Power), was authorized to charge a 15.72% return on common equity, a 12.02% overall return on rate base, and received a $15.4 Million annual base rate increase bringing its total annual revenues in excess of $184 Million. The Pennsylvania Supreme Court's denial of the annual amortization claim for the cancelled plants at issue amounted to only $957,000. Despite the Pennsylvania Supreme Court's order, Penn Power has continued to operate successfully, has maintained its financial integrity, and its ability to attract capital.

ests, both existing and foreseeable. 390 U.S. at 792 (emphasis added).

Section 1315 of the Code and the Supreme Court of Pennsylvania's interpretation thereof allowed for consideration of the present and the future public interest. Rather than signalling to the regulated utility that *any* prudent investment would produce a return of and on that investment regardless of whether the investment ever served the public, the Pennsylvania Supreme Court chose to protect present and future ratepayers from such an unwarranted constitutional entitlement. However, the Pennsylvania Supreme Court did assure the Appellants through other adjustments in its ratemaking process the ability to attract necessary capital, maintain its financial integrity and fairly compensate the utility investors for the risks they had assumed. The fact that one particular investment never produced used and useful public utility property and the Court's denial of a return of and on that investment did not so damage the Appellants that they could not continue to operate successfully. No case ever decided by this Court or the lower federal courts have bestowed a constitutional right for utility investors to recover a return of and on any prudent investment without consideration of any other factors.

Denver Union Stock Yard Co. v. U.S., 304 U.S. 470 (1938), established the boundaries of a utility investor's right to recover costs in a specific investment. The Court stated that the due process clause of the Fifth Amendment assures utility investors rates which are sufficient to yield a reasonable rate of return on the value of property used, at the time it is being used, to render the services, but such rates cannot be per se excessive and extortionate. 304 U.S. at 475. However, the Court cautioned that the regulated entity is not entitled to have included any property not "used and useful" for that purpose. *Id.* Just as the Court refrained from creating an additional constitutional right to the return of or on

all prudent utility investment in the *Denver Union Stock Yard* case, so should the Court refrain from conferring such a substantial constitutional entitlement on the Appellants in this case.

The establishment of the used and useful principle in the *Denver Union Stock Yard* case confirmed an extended series of cases, all of which specifically refrained from unreasonably expanding the constitutional entitlements of utility investors. *See Smyth v. Ames*, 169 U.S. 466 (1898); *Willcox v. Consolidated Gas Co.*, 212 U.S. 19 (1909); *Minnesota Rate Cases*, 230 U.S. 352 (1913); *Bluefield Waterworks & Improvement Co. v. Public Service Comm'n*, 262 U.S. 679 (1923); *Board of Public Utility Commissioners v. New York Telephone Co.*, 271 U.S. 23 (1926); *Los Angeles Gas Corp. v. Railroad Commission*, 289 U.S. 287 (1933); *St. Joseph Stock Yards Co. v. U.S.*, 298 U.S. 38 (1936).

The lower federal courts have not chosen to expand the interpretation of this extended line of cases based upon the Court's teachings in *Hope* and *Permian*. The novel arguments raised by Appellants and the amici have not been adopted by any court of which IECPA, ELCON or AISI are aware. The used and useful principle "has stood as a bedrock principle of utility rate regulation for nearly a century" and should not be struck down by the Court in a thinly veiled attempt, by the Appellants and amici supporting the Appellants, to create a constitutional entitlement to a return of or on every dollar invested by regulated utilities without respect to whether ratepayers are ever provided with any benefit from that investment. *Kentucky Utilities Co. v. FERC*, 760 F.2d 1321, 1324 n.4 (D.C. Cir. 1985). States must retain the discretion of employing the used and useful principle on a case-by-case basis to decide whether a proper balancing of ratepayer and shareholder interests requires or does not require a return of or on prudent investment. Otherwise, current ratepayers would bear more than the legitimate costs of providing service to them.

The result sought by Appellants would be inconsistent with the United States Court of Appeals for the District of Columbia decision in *Natural Gas Pipeline Co. v. FERC*, 765 F.2d 1155, 1157 (D.C. Cir. 1985), *cert. denied*, 106 S. Ct. 794 (1986). That decision characterized the "used and useful" principle as a "bedrock" of utility regulation. It capsulized the principle as simply requiring that costs associated with electric power plants be paid by the ratepayers who benefit from the plant. 760 F.2d at 1324, fn.4. Ratepayers of the Appellants in this proceeding will never benefit from the investments in the cancelled nuclear plants in question and thus should not be constitutionally required to bear the cost responsibility of those investments.

The United States Court of Appeals for the District of Columbia Circuit most recently addressed the constitutional issues raised by the Appellants in *Jersey Central Power & Light Co. v. Federal Energy Regulatory Commission*, 810 F.2d 1168 (D.C. Cir. 1987) and confirmed the constitutionality of employing the used and useful test. After an extensive review of the standards established in *Hope* and *Permian Basin*, the court characterized those teachings as "straightforward". *Id.* at 1177. In reviewing rate orders, the courts must determine whether or not the end result of such orders constitute a reasonable balancing, based on factual findings, of the investor interests in maintaining financial integrity and access to capital markets and the consumer interest in being charged nonexploitative rates. *Id.* at 1177-1178. While the court concluded in *Jersey Central* that it was impossible to answer the question of whether including the unamortized portion of cancelled plant in rate base would exploit consumers in that case, or whether its exclusion, on the facts in the case, constituted confiscation from the utility, such a determination of the "central point" can be made in the case which is the subject of this appeal. *Id.* at 1181. The court specifically stated, "the Commission is not precluded from employing 'used and useful' or any other specific rate setting formula" and the case was only remanded to the Federal Energy Regulatory Commission because no hearing had been held consistent with this Court's directives in *Hope* and *Permian Basin*. The *Jersey Central* court went on to require the Commission to ensure that the resulting rate is just and reasonable. *Id.* at 1187.

The *Jersey Central* decision is also instructive on the issue of what constitutes an unconstitutional taking of utility investor property. In his concurring opinion, Judge Starr indicated that such a taking occurs only when a regulated rate is confiscatory, which is a shorthand way of saying that an unreasonable balance has been struck in the regulation process so as unreasonably to favor ratepayer interests at the substantial expense of investor interests.

> Thus, in my view, a taking does not occur when financial resources are committed to the enterprise. That is especially so since the utility's capital investment is made not simply in satisfaction of legal obligations to provide service to the public, but in anticipation of profits on the investment. The utility is not a servant to the state; it is a for-profit enterprise which incurs legal obligations in exchange for state-conferred benefits. A profit-seeking capital investment is scarcely the sort of deprivation of possession, use, enjoyment, and ownership of property which can conceptually be deemed a taking. *Id.* at 1189.

This Court should not now depart from its decisions in *Hope* and *Permian Basin* as interpreted by the lower federal courts in each of the proceedings discussed above. No need exists for the establishment of a constitutional entitlement in each and every utility investor to recover a return of or on all prudent investments without regard to the used and useful nature of those investments in providing public utility service.

II. This Court Has Regularly Dismissed Proceedings Which Have Raised The Identical Constitutional Arguments Made By Appellants In This Case.

This Court's dismissal of comparable proceedings applying the used and useful principle indicates it was not overridden by *Hope* and that a utility investor's alleged right to the recovery of or on all prudent investments is not of constitutional dimension.

Through a dismissal for want of a substantial federal question, this Court has refused to reverse decisions on the merits upholding Pennsylvania's and other states' denial of cost recovery on utility investment in nuclear power plants out of service for an extended period due to a nuclear accident. *Pennsylvania Electric Co. v. Pennsylvania Public Utility Comm'n*, 509 Pa. 324, 502 A.2d 130 (1985), *appeal dismissed sub nom. Metropolitan Edison Co. v. Pennsylvania Public Utility Comm'n*, 476 U.S. 1137 (1986). *See also Jersey Central Power & Light Co. v. Board of Public Utilities*, 466 U.S. 947 (1984). The Court dismissed several other cases, some of which involved the same cancelled nuclear plants subject to this case. *Cleveland Electric Illuminating Co. v. Public Utilities Comm'n*, 4 Ohio St.3d 107, 447 N.E.2d 746, *appeal dismissed*, 464 U.S. 802 (1983); *Cleveland Electric Illuminating Co. v. Public Utilities Comm'n*, No. 82-165 (Ohio, July 7, 1982), *appeal dismissed*, 459 U.S. 1094 (1983); *Office of Consumers' Counsel v. Public Utilities Comm'n*, 67 Ohio St.2d 153, 423 N.E.2d 820 (1981), *appeal dismissed sub nom., Cleveland Electric Illuminating Co. v. Office of Consumers' Counsel*, 455 U.S. 914 (1982); *Northern Indiana Public Service Co. v. Citizens Action Coalition of Indiana, Inc.*, 485 N.E.2d 610 (Ind. 1985), *appeal dismissed and cert. denied*, 476 U.S. 1137 (1986). These decisions confirm that *Hope* did not reverse or override the application of the used and useful principle.

The decision by the Pennsylvania Supreme Court to deny the Appellants a return of and on its investment

in the subject cancelled nuclear power plants was not unique. The highest state court in Ohio reached an identical result under its own public utility law and this Court has dismissed three separate appeals which argued that the denial of such cost recovery represented an unconstitutional confiscation of property. One of those dismissals, *Cleveland Electric Illuminating Co. v. Public Utilities Comm'n*, 4 Ohio St.3d 107, 447 N.E.2d 746, *appeal dismissed*, 464 U.S. 802 (1983) was for want of a substantial federal question, thus, constituting a decision on the merits. *See Meek v. Pittenger*, 421 U.S. 349, 367 N. 16 (1975). The Court dismissed two other appeals for lack of jurisdiction or lack of a properly presented federal question in *Cleveland Electric Illuminating Co. v. Public Utilities Comm'n*, No. 82-165 (Ohio, July 7, 1982), *appeal dismissed*, 459 U.S. 1094 (1983), and in *Office of Consumers' Counsel v. Public Utilities Comm'n*, 67 Ohio St.2d 153, 423 N.E.2d 820 (1981), *appeal dismissed sub nom., Cleveland Electric Illuminating Co. v. Office of Consumers' Counsel*, 455 U.S. 914 (1982). This Court most recently dismissed an appeal from the highest court of the state of Indiana also addressing the denial of recovery of cancelled plant costs. *See Northern Indiana Public Service Co. v. Citizens Action Coalition of Indiana, Inc.*, 485 N.E.2d 610 (Ind. 1985), *appeal dismissed* and *cert. denied*, 476 U.S. 1137 (1986).

The Court's action in these cases confirms that the used and useful principle of utility regulation has a continuing place in assuring utility's ratepayers that their interests are properly balanced with those of the utility's investors. Absent the used and useful principle, the balance swings unconscionably to the side of the utility investor and would result in ratepayers being required to absorb the cost of any and all prudent investment made by the utilities regardless of whether that investment ever provides any benefit to ratepayers.

CONCLUSION

The Fifth and Fourteenth Amendments do *not* constitutionally require states to allow recovery of or on prudently incurred investments, including, but not limited to, cancelled electric generating units without a consideration of whether those investments constitute used and useful utility property. The Court should reject the Appellants' contention that a prudence-only standard is required by the *Hope* and *Permian Basin* cases. In order for states to properly balance the interests of utility investors against utility ratepayers consistent with the directives of *Hope* and *Permian*, the used and useful principle must be continued for ratepayers' protection. The balancing requirements of *Hope* and *Permian* necessitate state discretion on a case-by-case basis to deny or to allow a return of or on prudent investment based on all the facts presented.

In any case, this Court should refrain from creating an additional constitutional entitlement to utility investors which is not available to investors in the private competitive marketplace. If the system of regulation is to operate appropriately as a mirror of the competitive marketplace, utility investors must expect to bear an appropriate portion of the business risk inherent in prudent managerial decisions regarding plant construction. These risks include the possibility of making a prudent investment which never produces economic benefits for ratepayers nor used and useful utility property. In such events, a state must have the discretion of pursuing the appropriate balancing of interests between the investor and the ratepaper by denying recovery of or on property which is not used and useful for customer service. Such denial does not confiscate constitutionally protected property interests since the loss of value of the investment for which recovery is denied results from action of the free market rather than state regulation. The utilities are not denied any recovery which they

would have received in a competitive market. Therefore, Section 1315 of the Pennsylvania Public Utility Code and the "unspecified ratemaking legislation" must be upheld by this Court as being consistent with the Constitution and this Court's precedents in *Hope* and *Permian Basin*.

Respectfully submitted,

HENRY R. MACNICHOLAS
H. LEE ROUSSEL
DAVID M. KLEPPINGER *
MCNEES, WALLACE & NURICK
100 Pine Street
P.O. Box 1166
Harrisburg, PA 17108-1166
(717) 232-8000
Attorneys for Industrial Energy Consumers of Pennsylvania, Electricity Consumers Resource Council and American Iron and Steel Institute

* Counsel of Record

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